CAIIB 2026

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RISK MANAGEMENT

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CHAPTER 01
Why Banks are Special

Oct/Nov 2015

1. A wealthy individual considers lending surplus funds directly to a local manufacturing business. However, to ensure the business generates sufficient income to repay the loan, the individual must periodically audit the business's operations and financial health. The individual ultimately decides against lending due to the considerable time and cost involved. This situation illustrates which of the following obstacles?
(A) Price risk
(B) Adverse selection
(C) Liquidity risk
(D) Monitoring cost

May/June 2008

2. Consider the following statements regarding the qualitative difference between bank deposits and bank loans during asset transformation:
I Bank deposits are typically in smaller amounts and of relatively shorter maturities.
II Bank loans are relatively longer and riskier than deposits, with repayment schedules typically extending over several years.
Which of the above statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2022

3. Consider the following statements regarding Lender-Savers and Borrower-Spenders:
I Households act exclusively as Lender-Savers and never as Borrower-Spenders.
II Business firms can function as both Lender-Savers and Borrower-Spenders.
III Government entities are categorized only as Borrower-Spenders.
IV Foreign entities can be considered as Lender-Savers.
V Households can act as both Lender-Savers and Borrower-Spenders.
Which of the above statements are correct?
(A) Only (I), (II), and (IV)
(B) Only (II), (IV), and (V)
(C) Only (II), (III), and (V)
(D) Only (I), (III), and (IV)

May/June 2019

4. Consider the following statements regarding maturity transformation:
I Maturity mismatch inherently exposes a bank to liquidity risk and interest rate risk.
II Banks are called upon to transfer funds from agents demanding short-term deposits to agents with long-term financing needs.
III Banks cannot hedge their credit risk associated with maturity mismatch under any circumstances.
Which of the above statements is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2006

5. Banks offer a large number of assets and liability products and services as financial intermediaries. Which of the following is NOT traditionally classified as one of the core services provided by banks?
(A) Deposit collection
(B) Managing the physical production of manufacturing firms
(C) Payment services
(D) Loan underwriting

May/June 2012

6. Which of the following is the correct pair illustrating how banks provide products with better liquidity characteristics to their customers?
(A) Fixed deposit accounts — Strictly prohibit premature closure under any expected or

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unexpected expenditure circumstances.
(B) SB and Current accounts — Allow customers to withdraw cash at any time to meet day-to-day requirements.
(C) Asset Transformation — Requires savers to lock in funds for periods longer than the borrowers' loan tenures.
(D) Corporate debentures — Provide average household savers with zero price risk and instant cash conversion.

Oct/Nov 2018

7. In the context of economic units, households, businesses, and governments whose current need exceeds their current income and sources of funds are defined as which of the following?
(A) Savings surplus units
(B) Savings deficit units
(C) Financial intermediaries
(D) Foreign entities

May/June 2023

8. What is the specific limit of deposit insurance cover provided per depositor by the Deposit Insurance and Credit Guarantee Corporation (DICGC) in India?
(A) ₹ 1 lakh
(B) ₹ 2 lakh
(C) ₹ 5 lakh
(D) ₹ 10 lakh

Oct/Nov 2009

9. Which of the following is an incorrect statement regarding the transaction costs faced by savers and financial intermediaries?
(A) Transaction cost involves the time and money required to conduct due diligence before a financial transaction.
(B) Financial intermediaries substantially increase per unit transaction costs as the size of their operations expands.
(C) An average saver investing directly in a commercial firm faces high information collection costs.
(D) Technology plays a supportive role in allowing financial intermediaries to reduce transaction costs.

May/June 2016

10. The "Parable of the Fisherman", where thirty fish are lent in exchange for sixty fish later, is most appropriate in illustrating which of the following broad economic principles?
(A) The requirement of a formal fiat currency system to facilitate and regulate trade.
(B) The inevitable problem of adverse selection when lending to unmonitored borrowers.
(C) The trade-off between current consumption and investment for future consumption.
(D) The mechanics of fractional-reserve banking and the resulting creation of money.

Oct/Nov 2011

11. Consider the following statements regarding risk sharing:
I Risk sharing refers to the combining and sharing of the financial risk the depositors face.
II Financial intermediaries create and sell products with risk characteristics that depositors are comfortable with, and use the funds to acquire far riskier assets.
Which of the above statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2005

12. The following question consists of two statements, Assertion (A) and Reason (R). Answer the question by selecting the appropriate option:
Assertion (A): The average household saver generally remains stuck with corporate equity or debt till their maturity in the absence of secondary markets.
Reason (R): The lack of liquidity prompts households to hold their savings in cash rather than investing directly with corporates.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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Oct/Nov 2014

13. The process of translating the product specifications requested by savers into products requested by borrowers, specifically turning bank liabilities into bank assets with divergent characteristics, is defined as:
(A) Asset transformation
(B) Monetary transmission
(C) Financial inclusion
(D) Risk sharing

May/June 2021

14. An institution that stands between two other parties and operates between a saver who deposits money and a borrower who receives a loan is defined as a:
(A) Savings deficit unit
(B) Foreign entity
(C) Financial intermediary
(D) Central bank

Oct/Nov 2007

15. Identify the correct statement regarding the risks assumed by banks when providing maturity transformation services to the economy:
(A) By matching consumer time horizons with business time horizons, banks completely eliminate liquidity risk from the financial system.
(B) Offering long-term mortgage loans funded by short-term liabilities inherently protects a bank from interest rate risk.
(C) Maturity mismatching is legally prohibited for modern-day banking institutions.
(D) Banks manage mismatch risk using markets and tools like swaps and securitization.

May/June 2025

16. Why is the transfer of funds from savers to borrowers considered vital to the economy?
(A) It fosters economic growth by enabling borrowers to produce more goods and services.
(B) It eliminates the necessity for central bank oversight and monetary interventions.
(C) It prevents foreign entities from participating in or influencing domestic markets.
(D) It replaces fractional-reserve banking with a model based solely on direct investment.

Oct/Nov 2024

17. Bank Omega collects ₹ 1,000 from each of one million depositors. It utilizes the resultant ₹ 1 billion to issue 10,000 loans of ₹ 100,000 each. Based on the concept of diversification, what is the specific mathematical share of the credit risk that each individual depositor bears in each of the 10,000 loans?
(A) 1/10,000
(B) 1/100,000
(C) 1/1,000,000
(D) 1/1,000

May/June 2010

18. In the "Parable of the Fisherman", arrange the following economic events illustrating the evolution of financial concepts in the correct chronological order:
1. The fisherman sits by a lake and catches a fish a day with his bare hands.
2. The friend agrees to lend thirty fish on the condition of receiving sixty fish at the end.
3. The fisherman realizes he needs to stop fishing for a month to make a net but might starve.
4. The fisherman conceptualizes a trade-off between current consumption and investment.

(A) 1-3-2-4
(B) 1-4-3-2
(C) 1-2-3-4
(D) 1-4-2-3

Oct/Nov 2005

19. A large commercial bank engages a top-tier law firm to produce a comprehensive universal set of loan documents. The bank proceeds to use this identical set of documents repeatedly across thousands of its loan transactions. This scenario is a practical application of which economic advantage?
(A) The problem of asymmetric information
(B) The mechanics of asset transformation
(C) The specific issue of adverse selection
(D) Economies of scale in transaction costs

May/June 2020

20. Identify the incorrect statement regarding depositors at risk and the safety net:
(A) Deposit insurance generally offers unlimited protection to all global depositors.
(B) Depositors who lend money to a bank

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typically do not evaluate its credit quality.
(C) Depositors generally assume their deposit is safe and will be returned on demand.
(D) Governments create safety nets like deposit insurance to protect small depositors.

Oct/Nov 2021

21. A retail shop owner in India unexpectedly needs substantial funds to repair damages caused by a sudden flood. To access funds, the owner prematurely closes a fixed deposit account before its designated maturity date. This scenario practically highlights the banking function of providing:
(A) Moral hazard alignment
(B) Asymmetric information aggregation
(C) Products with better liquidity characteristics
(D) The money multiplier effect

May/June 2013

22. Mr. Sharma invests directly in financial instruments issued by a corporate entity. Suddenly, he requires funds for a medical emergency and attempts to sell these securities in a financial market. He discovers that the price at which he can sell them is significantly lower than the original price he paid. This scenario primarily exemplifies which of the following risks?
(A) Moral hazard
(B) Price risk
(C) Maturity mismatch
(D) Asymmetric information

Oct/Nov 2017

23. Which of the following is a correct statement regarding the core services traditionally provided by banks?
(A) Deposit collection is limited to individual households and excludes all business firms.
(B) Loan underwriting involves extending credit without evaluating a borrower's history.
(C) Core banking services intentionally aim to increase transaction costs for consumers.
(D) Payment services involve making payments for customers using their bank accounts.

May/June 2006

24. Which of the following most appropriately describes the primary mechanism through which banks achieve diversification benefits?
(A) By keeping all deposited funds in liquid cash reserves rather than lending them out.
(B) By offering high-price products to savers on the liability side while investing in low-risk products on the asset side.
(C) By exclusively financing the government sector to eliminate all possibilities of firm-specific risk.
(D) By spreading millions of deposits across thousands of loans to minimize individual stakes.

Oct/Nov 2013

25. The following question consists of two statements, Assertion (A) and Reason (R). Answer the question by selecting the appropriate option:
Assertion (A): Depositors assume a degree of risk when they place their funds in a bank, necessitating government-created safety nets.
Reason (R): While banks evaluate the creditworthiness of borrowers when underwriting a loan, depositors typically do not evaluate the credit quality or repayment ability of the bank.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2015

26. In an economy operating without efficient financial institutions, the fund flow between surplus units and deficit units is likely to be very low. Which of the following conceptually explains why an average household saver finds direct investment in corporate financial instruments unattractive?
(A) The central bank strictly prohibits direct lending by households to corporates.
(B) The elimination of the money multiplier

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effect in direct transactions.
(C) The absolute certainty that business firms will generate sufficient income to repay the loan.
(D) The presence of high monitoring costs, lack of liquidity, and exposure to price risk.

Oct/Nov 2012

27. A young family prefers to keep their savings in a highly liquid form to absorb unexpected medical shocks. A separate manufacturing business requires long-term financing to establish a new production facility over a ten-year horizon. A bank accepts the family's short-term funds and extends a long-term mortgage loan to the business. This specific scenario demonstrates:
(A) Maturity transformation
(B) Adverse selection
(C) Creation of money
(D) Gridlock in the payment system

May/June 2011

28. Consider the following economic concepts illustrated by the "Parable of the Fisherman":
I The general trade-off between current consumption and investment.
II The link between the level of investment and investable savings.
III The concept of a capital sum lent/ borrowed and a rate of interest charged.
IV The monetary transmission mechanism governed by a central authority.
Which of the above statements is/are correct?
(A) Only (I), (II), and (III)
(B) Only (I), (III), and (IV)
(C) Only (II), (III), and (IV)
(D) Only (I), (II), and (IV)

Oct/Nov 2020

29. The following question consists of two statements, Assertion (A) and Reason (R). Answer the question by selecting the appropriate option:
Assertion (A): Financial intermediaries like banks are in a position to carry out services at a substantially reduced transaction cost.
Reason (R): As the size of transactions increases, the large scale allows banks to take advantage of economies of scale, resulting in a reduction in the per unit transaction cost.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2022

30. Conceptually, how do banks primarily generate revenue and profit while functioning as financial intermediaries?
(A) By charging the exact same interest rate on loans as the interest rate paid on deposits.
(B) By eliminating the requirement for all cash reserves mandated by national regulators.
(C) By completely avoiding the complex process of asset transformation for all clients.
(D) By utilizing the spread between interest received from borrowers and paid to savers.

Oct/Nov 2023

31. The following question consists of two statements, Assertion (A) and Reason (R). Answer the question by selecting the appropriate option:
Assertion (A): In the absence of adequate information, charging a high average rate of interest to all borrowers causes good quality borrowers to withdraw from the market.
Reason (R): Charging an average rate to compensate for bad credit risk means the good quality borrower is penalized, leaving only the borrower with high credit risk, which is the core of the adverse selection problem.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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May/June 2017

32. The size of the money multiplier, which determines the amount of money created from an initial deposit, finally depends on which of the following?
(A) The magnitude of the deposit insurance safety net.
(B) Bank cash assessments and the regulatory requirements of central authorities.
(C) The specific exchange rate channel active in the economy.
(D) The amount of physical outlets reduced by digital transformation.

Oct/Nov 2019

33. Conceptually, what is the primary distinction between the problem of adverse selection and the problem of moral hazard in financial markets?
(A) Adverse selection relates to transaction costs, while moral hazard relates to liquidity costs.
(B) Selection occurs before a transaction, while hazard occurs after a transaction is made.
(C) Adverse selection is caused by symmetric information, while moral hazard is caused by lack of safety nets.
(D) Adverse selection only impacts the depositors, while moral hazard exclusively impacts the central bank.

May/June 2009

34. Consider the following statements regarding Financial Inclusion:
I "Financial exclusion" refers to processes preventing poor and disadvantaged social groups from gaining access to the financial system.
II It ensures access to financial services and timely credit needed by vulnerable groups at an affordable cost.
III It broadens the resource base of the financial system by developing a culture of savings among rural populations.
IV It primarily relies on the expansion of usurious money lenders to facilitate easy access to formal credit.
Which of the above statements is/are correct?
(A) Only (I), (II), and (III)
(B) Only (II), (III), and (IV)
(C) Only (I), (III), and (IV)
(D) Only (I), (II), and (IV)

Oct/Nov 2008

35. Conceptually, the monetary transmission mechanism is defined as the link between:
(A) Monetary policy and aggregate demand
(B) Short-term deposits and long-term loans
(C) Asymmetric information and adverse selection
(D) Transaction costs and economies of scale

May/June 2018

36. Consider the following statements about the dual functions of digital transformation in banking:
I It enables banking organizations to offer new service channels through electronic platforms.
II It significantly increases the bank's operating costs by mandating a massive expansion of physical outlets.
III It reduces operating costs by limiting the number of physical outlets.
Which of the above statements is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2016

37. In the context of economic units, households, businesses, and governments whose current need exceeds their current income and sources of funds are defined as which of the following?
(A) Savings surplus units
(B) Savings deficit units
(C) Financial intermediaries
(D) Foreign entities

May/June 2014

38. Consider the following statements regarding bank credit allocation:
I A bank's willingness to lend to a firm serves as a valuable signal that is readily observed by capital markets and potential creditors.
II Bank loans represent a minor source of funding that rarely requires renewal, making creditworthiness evaluations unnecessary.
Which of the above statements is/are correct?
(A) Only (I)

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(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2025

39. Bank Sigma receives an initial deposit of ₹ 10,000. Bank regulators mandate a required-reserve ratio of 10%. Bank Sigma retains ₹ 1,000 at the central bank and extends a ₹ 9,000 loan to a borrower. The borrower spends the money, which is subsequently deposited into Bank Delta. Bank Delta then retains 10% and lends out the remainder. This continuous cycle represents which economic phenomenon?
(A) Adverse selection
(B) Economies of scale
(C) Risk sharing
(D) Creation of money via the multiplier effect

May/June 2007

40. An entrepreneur obtains a substantial business loan from a bank to expand a manufacturing plant. Once the loan is disbursed, the entrepreneur secretly uses the funds to engage in highly speculative and risky day-trading in the stock market, an activity the bank would not have approved. This scenario best illustrates:
(A) Adverse selection
(B) The money multiplier effect
(C) Digital banking transformation
(D) Moral hazard

Oct/Nov 2010

41. During the year 2020, a major economic lockdown restricted physical movement. In response, Bank Epsilon rapidly scaled up its virtual banking infrastructure, leading its customers to routinely execute daily business purchases and account operations digitally without branch visits. This shift was firmly impacted by:
(A) The expansion of fractional reserves
(B) The COVID-19 pandemic
(C) The elimination of deposit insurance
(D) The failure of the global financial crisis

May/June 2024

42. A prospective buyer is looking to purchase a used 2015 Honda Accord. Aware that there are cars in immaculate condition and cars with mechanical issues in the market, but unable to distinguish between them, the buyer is only willing to pay an average price of 15,000. Consequently, the owner of a well-maintained car worth 20,000 refuses to sell, leaving only poor-condition cars in the market. This scenario is a classic illustration of:
(A) Economies of scale
(B) Maturity transformation
(C) Adverse selection
(D) Moral hazard

Oct/Nov 2022

43. A local manufacturing enterprise requires frequent renewal of its funding. After rigorous due diligence, a major commercial bank approves a large credit line for the enterprise. Immediately thereafter, the enterprise's suppliers offer better trade credit terms, and independent investors show interest in the firm's equity. This scenario demonstrates the bank's role in:
(A) Generating the money multiplier effect
(B) Providing a valuable signal through credit allocation
(C) Overcoming the gridlock in payment services
(D) Insulating its risk management system

May/June 2023

44. Consider the following transmission channels identified for influencing real sector activity during the implementation of monetary policy:
I The quantum channel relating to money supply and credit.
II The interest rate channel relating to money supply and credit.
III The exchange rate channel.
IV The asset price channel.
Which of the above statements is/are correct?
(A) Only (I), (II), and (III)
(B) Only (II), (III), and (IV)
(C) Only (I), (III), and (IV)
(D) (I), (II), (III), and (IV)

Oct/Nov 2014

45. Match the items in List I with the descriptions in List II and select the correct answer using the codes given below:
List I: (Category)
P. New electronic platforms
Q. New service points
R. Digital technologies impact

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S. COVID-19 impact

List II: (Attribute)

1. e-branch stores, POS
2. Helped in rapid digitalization of financial transactions
3. e-banking, virtual banking
4. Save time, reduce operating costs, optimize monitoring

(A) P-3, Q-1, R-4, S-2
(B) P-1, Q-3, R-2, S-4
(C) P-4, Q-2, R-3, S-1
(D) P-3, Q-4, R-1, S-2

May/June 2012

46. What is the definition of the term used to describe a situation where one party to an economic transaction possesses greater material knowledge than the other, often referred to as an "information failure"?

(A) Maturity mismatch
(B) Asymmetric information
(C) Transaction cost
(D) Financial intermediation

Oct/Nov 2009

47. Identify the incorrect statement regarding payment services provided by the banking system:

(A) The payment services act akin to a circulatory system keeping money moving to keep the economy healthy.
(B) Digitalization of the payment system has completely eliminated all cyber risks for new technology users.
(C) Any breakdown in the clearing and transfer systems would produce gridlock in the payment system with resultant harmful effects.
(D) Online payments are becoming the standard, replacing paper checks of the 20th century.

May/June 2005

48. Identify the correct statement regarding moral hazard in the context of financial markets:

(A) Moral hazard is a problem created by symmetric information prior to a transaction.
(B) Hazard arises when borrowers engage in activities undesirable to the lender.
(C) Moral hazard implies that the borrower knows less about how their funds will be used than the lender does.
(D) Moral hazard guarantees that loans will never become bad in due course.

Oct/Nov 2018

49. Arrange the following events in a fractional-reserve banking system that lead to the money multiplier effect in the correct chronological order:

1. This newly lent money finds its way back into the banking system as a deposit in other banks.
2. An initial deposit is made by a saver into a commercial bank.
3. The process of relending repeats itself a number of times.
4. After keeping the required reserve, the bank lends the rest of the money to borrowers.

(A) 2-4-1-3
(B) 2-1-4-3
(C) 4-2-1-3
(D) 2-4-3-1

May/June 2019

50. The Reserve Bank of India alters its monetary policy to stimulate the economy. Following this, Commercial Bank X immediately lowers its lending interest rates. This reduction lowers the borrowing cost for a major domestic manufacturer, prompting the firm to increase its physical investment and expand operations. This sequence of events is an application of:

(A) The problem of adverse selection
(B) The parable of the fisherman
(C) Traditional monetary transmission mechanism
(D) Direct lending by savings surplus units

Oct/Nov 2006

51. A regional bank decides to expand its operations into several remote villages. Instead of constructing brick-and-mortar branches, the bank deploys Point of Sale (POS) terminals and introduces an intuitive e-banking application. As a result, villagers gain full banking access while the bank's operational overheads drop. This scenario is an example of:

(A) Maturity mismatch
(B) The market for lemons
(C) Pure monetary transmission
(D) Digital banking and inclusive banking

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May/June 2021

52. Which economist authored the 1970 paper titled "The Market for 'Lemons'", explaining why markets with asymmetric information may not function well?
(A) Joseph E. Stiglitz
(B) A. Michael Spence
(C) C. Rangarajan
(D) George A. Akerlof

Oct/Nov 2015

53. Match the items in List I with the descriptions in List II and select the correct answer using the codes given below:
List I: (Channel)
P. Quantum channel
Q. Interest rate channel
R. Exchange rate channel
S. Asset price channel
List II: (Variable)
1. Relates to asset prices
2. Relates to foreign exchange dynamics
3. Relates to money supply and credit
4. Relates to money supply, credit, and interest rates
(A) P-3, Q-4, R-2, S-1
(B) P-4, Q-3, R-1, S-2
(C) P-1, Q-2, R-3, S-4
(D) P-3, Q-1, R-4, S-2

May/June 2008

54. Which of the following is the correct pair representing two important payment services performed by banks that directly benefit the economy?
(A) Asset transformation and maturity mismatch
(B) Moral hazard and adverse selection
(C) Clearing and transfer of funds
(D) Information asymmetry and credit allocation

Oct/Nov 2011

55. Which of the following is the most appropriate reason why a bank's willingness to lend to a firm acts as a special and valuable signal in the economy?
(A) Banks are specialists in establishing and continually reevaluating firm creditworthiness.
(B) It proves the firm has no transaction costs.
(C) It confirms the bank has unlimited fractional reserves.
(D) It indicates that the firm operates exclusively in the priority sector.

May/June 2016

56. Match the items in List I with the descriptions in List II and select the correct answer using the codes given below:
List I: (Concept)
P. Asymmetric Information
Q. Adverse Selection
R. Moral Hazard
S. Risk Sharing
List II: (Description)
1. Risk arising when borrowers engage in activities undesirable from the lender's point of view after a transaction.
2. Circumventing the uncertainty of returns by selling products with comfortable risk characteristics to depositors.
3. Problem where the potential borrower most likely to produce an undesirable outcome is the most likely to seek a loan.
4. Information failure where one party possesses greater material knowledge than the other.
(A) P-4, Q-3, R-1, S-2
(B) P-3, Q-4, R-2, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-1, Q-2, R-4, S-3

Oct/Nov 2024

57. Which of the following is a correct statement regarding the benefits of financial inclusion?
(A) It brings low-income groups into the formal banking sector, helping to protect their wealth in times of crisis.
(B) It encourages low-income groups to rely exclusively on informal banking sectors for their primary credit needs.
(C) It increases the exploitation of vulnerable sections by strictly limiting their access to all formal credit lines.
(D) It functions solely as a tool to increase the transaction costs of implementing national monetary policy.

May/June 2010

58. Banks attempt to overcome the challenges posed by adverse selection through various methods. Which of the following is NOT

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a standard method for mitigating adverse selection?
(A) Completely eliminating all risk sharing mechanisms
(B) Rigorous due diligence
(C) Appropriate collateral management policy
(D) Information gathering and analysis

Oct/Nov 2005

59. Consider the following statements regarding the creation of money by banks:
I The banking system can expand the money supply of a country beyond the amount targeted by the central bank.
II Banks expand the amount of bank deposits when they lend money.
III Banks are completely unlimited in the total amount they can lend out from deposits.
IV The required-reserves ratio obliges banks to keep a minimum percentage of deposits at an account at the central bank.
V An initial bank loan typically creates more money than it initially lent out in a fractional-reserve system.
Which of the above statements is/are correct?
(A) Only (I), (II), and (III)
(B) Only (I), (II), IV, and (V)
(C) Only (II), (III), (IV), and (V)
(D) Only (I), (III), (IV), and (V)

May/June 2020

60. Identify the incorrect statement regarding the channels of monetary policy transmission:
(A) How transmission channels function depends on the economy's stage of development and underlying financial structure.
(B) The transmission channels function entirely independently and are mutually exclusive of one another.
(C) In an open economy, one would expect the exchange rate channel to be important.
(D) In an economy where banks are the major source of finance, the credit channel could be a major conduit for monetary transmission.

Oct/Nov 2021

61. Consider the following statements:
I The asset transformation function refers to transforming the bank's liability into bank's assets.
II Banks are able to reduce part of their portfolio credit risk primarily by concentrating entirely on the areas of strength.
III Monetary transmission mechanism is defined as the link between aggregate demand and monetary policy.
Which of the above statements is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

May/June 2013

62. The economy relies on banks to act as a specialist in the measurement and management of various types of financial risks. Which of the following is NOT a consequence of banks failing to perform this critical function?
(A) Immediate elimination of the money multiplier effect
(B) Worldwide breakdown in credit markets
(C) A crisis of confidence that disrupts financial markets
(D) Threat to overall financial stability

Oct/Nov 2017

63. Which of the following is the most appropriate description of a highly liquid asset as provided by a financial intermediary?
(A) An asset that takes years to sell and results in a massive loss of value for the primary owner.
(B) A corporate bond with high price risk and no secondary market available for immediate trading.
(C) An asset that can be transformed into money quickly, easily, and at a low transaction cost.
(D) A loan extended to an unrated borrower with high monitoring costs and no repayment guarantee.

May/June 2006

64. Consider the following statements summarizing why banks are special:
I They perform the economic function of mobilizing funds from people with surplus money to finance those who need them.
II They provide financial services at a relatively higher cost because they fail to

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reap economies of scale.

III Information asymmetry gives rise to adverse selection and moral hazard, which banks address through due diligence and monitoring.

IV Banks are the medium which converts the monetary policy into functional reality.

V Banks provide the infrastructure to facilitate the payment system which is critical for the modern economy.

Which of the above statements is/are correct?

(A) Only (I), (III), (IV), and (V)
(B) Only (I), (II), (III), and (IV)
(C) Only (II), (III), (IV), and (V)
(D) Only (I), (II), (IV), and (V)

Oct/Nov 2013

65. Match the items in List I with the descriptions in List II and select the correct answer using the codes given below:

List I: (Scenario)

P. Dealing with prospective borrowers directly
Q. Financial Intermediary role
R. Asset Transformation consequence
S. Diversified portfolio

List II: (Mechanic)

1. Helps to diversify various risks
2. Pays interest to depositors and charges interest on loans
3. Involves high cost of monitoring, liquidity, and price risk
4. Gives rise to mismatches in maturities and re-pricing

(A) P-3, Q-2, R-4, S-1
(B) P-2, Q-3, R-1, S-4
(C) P-4, Q-2, R-3, S-1
(D) P-3, Q-4, R-2, S-1

May/June 2015

66. An individual returns from a late-night shift and urgently requires currency notes to pay for a taxi. The individual utilizes an automated teller machine (ATM) to instantly convert their deposit balance into cash. This scenario explicitly highlights the bank's function as a:

(A) Manager of financial risk
(B) Evaluator of adverse selection
(C) Conduit for asset transformation
(D) Provider of liquidity

Oct/Nov 2012

67. Identify the incorrect pair regarding conceptual evaluations of banking:

(A) Banks create money from initial deposit — Because of the fractional reserve system.
(B) Asymmetric information gives rise to moral hazard — Which takes place after the loan has been disbursed.
(C) Portfolio credit risk reduction — Achieved through the diversification process.
(D) Asset transformation function — Refers strictly to converting physical assets to monetary assets.

May/June 2011

68. Identify the incorrect pair of key definitions:

(A) Maturity Mismatch — A state where short-term assets and short-term liabilities perfectly align in time.
(B) Asset Transformation — Process of transforming bank liabilities into bank assets with divergent characteristics.
(C) Safety Net — Protection of banks' creditors against losses resulting from bank failures.
(D) Diversification — Investing in various financial instruments in order to reduce risk.

Oct/Nov 2020

69. As financial intermediaries, banks have to insulate their risk management system to protect financial stability. Which of the following statements represents an incorrect approach regarding the management of financial risk by banks?

(A) Relying on their superior capability to distinguish good borrowers from bad ones.
(B) Avoiding all credit risk assessments to maximize the total number of new loans approved for clients.
(C) Mitigating moral hazard through appropriate strategies and monitoring.
(D) Functioning as specialists in the measurement and management of risks.

May/June 2022

70. Match the items in List I with the descriptions in List II and select the correct answer using the codes given below:

List I: (Keyword)

P. Transaction cost
Q. Creation of money

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R. Moral hazard
S. Digitization

List II: (Context)

1. Risk arising when borrowers' post-transaction actions are undesirable.
2. Expanding broad money via the multiplier effect.
3. Cost of time and money spent on necessary due diligence.
4. Enabling service channels like e-banking and virtual banking.

(A) P-3, Q-2, R-1, S-4
(B) P-2, Q-3, R-4, S-1
(C) P-4, Q-1, R-2, S-3
(D) P-3, Q-4, R-1, S-2

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ANSWERS

1. (D) Monitoring cost
Lending directly to businesses often forces individual lenders to spend significant time and money auditing operations and financial health. This process ensures the borrower generates enough income for repayment. When such expenses become prohibitive, they represent monitoring costs. These costs act as a barrier to direct financing between surplus and deficit units in the economy.

2. (C) Both (I) and (II)
Asset transformation involves banks converting short-term, small-value liabilities into long-term, large-value assets. Bank deposits typically feature shorter maturities and smaller amounts, catering to household liquidity needs. In contrast, bank loans are generally riskier and involve longer repayment schedules spanning several years. This qualitative difference reflects how financial intermediaries manage the divergent needs of lenders and borrowers.

3. (B) Only (II), (IV), and (V)
Economic units are classified based on their funding needs. Business firms frequently act as both lender-savers and borrower-spenders depending on their cash flow. Households also occupy both roles, saving surplus income or borrowing for consumption. Foreign entities and governments participate similarly in financial markets. Understanding these dual roles is essential for identifying how funds circulate within the global financial system.

4. (A) Only (I) and (II)
Maturity transformation occurs when banks use short-term deposits to fund long-term loans. This mismatch inherently exposes financial institutions to liquidity and interest rate risks. While banks transfer funds between agents with different time horizons, they also employ sophisticated tools like swaps and securitization to manage these risks. Credit risk management remains a core function despite inherent maturity mismatches.

5. (B) Managing the physical production of manufacturing firms
Banks serve as financial intermediaries by providing specific core services to the economy. These include collecting deposits from savers, underwriting loans for borrowers, and facilitating payment services. Managing the physical production of manufacturing firms falls outside these financial functions. Banks focus on the flow of capital and financial risk management rather than the direct operational management of industrial enterprises.

6. (B) SB and Current accounts — Allow customers to withdraw cash at any time to meet day-to-day requirements.
Financial intermediaries provide products that offer superior liquidity compared to direct investments. Savings and current accounts allow customers to withdraw cash whenever necessary to meet immediate requirements. Unlike long-term corporate bonds or debentures, these bank products minimize price risk for small savers. This accessibility ensures that households can manage day-to-day expenditures while still participating in the formal financial system.

7. (B) Savings deficit units
Economic units are categorized based on their income relative to their spending needs. When households, businesses, or governments require more funds than their current income provides, they are termed savings deficit units. These units must borrow from the financial system to cover their shortfalls. Identifying these units helps in understanding the demand side of the credit market and fund allocation.

8. (C) ₹ 5 lakh
Deposit insurance provides a safety net for individual depositors in the event of a bank failure. In India, the Deposit Insurance and Credit Guarantee Corporation manages this protection. The specific coverage limit is set at five lakh rupees per depositor for both principal and interest amounts. This mechanism enhances

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public confidence in the banking system by protecting small-scale savings.

9. (B) Financial intermediaries substantially increase per unit transaction costs as the size of their operations expands.
Financial intermediaries substantially decrease per unit transaction costs as the size of their operations expands. Transaction costs encompass the time and money required to perform due diligence before a financial trade. Financial intermediaries actually reduce these costs by achieving economies of scale as their operations expand. While individual savers face high information costs when investing directly, banks use technology and specialized expertise to lower per-unit expenses. Scaling operations typically improves efficiency.

10. (C) The trade-off between current consumption and investment for future consumption.
The parable involving a fisherman and his friend illustrates fundamental economic choices. It highlights the trade-off between consuming resources immediately and investing them to enhance future productivity. By lending surplus fish, the saver earns interest while the borrower builds a net to increase his catch. This concept demonstrates the core relationship between current savings, investment, and future economic growth.

11. (C) Both (I) and (II)
Risk sharing involves financial intermediaries creating products with risk profiles that suit depositors. Banks use the funds gathered from these relatively safe deposits to acquire much riskier assets, such as commercial loans. This process combines and distributes financial risks across a broad base of participants. It allows savers to earn returns while remaining within their comfortable risk tolerance levels.

12. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Without active secondary markets, direct investments like corporate debt or equity become illiquid until maturity. This lack of easy cash conversion often discourages households from investing directly in corporations. Consequently, savers may choose to hold cash or bank deposits instead of long-term securities. Financial intermediaries resolve this by offering liquid products, bridging the gap between savers and corporates.

13. (A) Asset transformation
Asset transformation is the process where banks convert their liabilities into assets with different characteristics. Banks take short-term, liquid deposits and turn them into long-term, illiquid loans. This function allows the financial system to meet the specific requirements of both savers and borrowers simultaneously. It is a fundamental mechanism through which banks provide value as intermediaries in the economy.

14. (C) Financial intermediary
A financial intermediary is an institution that facilitates the flow of funds between two parties. It stands between savers who provide deposits and borrowers who require loans. By acting as a middleman, the intermediary manages risks and reduces transaction costs for both sides. Banks are the most common examples, playing a vital role in mobilizing capital within the modern economy.

15. (D) Banks manage mismatch risk using markets and tools like swaps and securitization.
Banks assume significant risks when performing maturity transformation, specifically liquidity and interest rate risks. To manage these mismatches, modern banking institutions use sophisticated financial markets and specialized tools. Instruments such as interest rate swaps and securitization allow banks to hedge their exposures. These strategies enable banks to continue funding long-term projects using short-term liabilities without compromising stability.

16. (A) It fosters economic growth by enabling borrowers to produce more goods and services.
The transfer of funds from savers to borrowers is essential for driving economic activity. It allows capital to reach those who can use it productively to create goods and services. This mobilization of idle resources fosters industrial expansion, infrastructure development, and overall national growth. Efficient financial intermediation ensures that surplus wealth is

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channeled into investments that benefit the entire ecosystem.

17. (C) 1/1,000,000
Diversification allows banks to spread credit risk across a massive number of participants. When a bank pools deposits from one million individuals to fund ten thousand loans, the risk is mathematically distributed. Each depositor's exposure to any single loan is reduced to a tiny fraction, specifically one millionth. This strategy minimizes the impact of individual loan defaults on total funds.

18. (A) 1-3-2-4
Economic development begins with basic resource gathering, followed by the recognition of needs for improved productivity and potential risks. In the fisherman parable, the individual first catches fish manually and then realizes the necessity of an investment period despite starvation risks. A lending agreement is then reached with a friend. Finally, this process formalizes the conceptual trade-off between consumption and investment.

19. (D) Economies of scale in transaction costs
Banks achieve significant efficiency by applying standardized processes to large volumes of transactions. Creating a single set of legal documents for thousands of loans reduces the per-unit cost of lending. This application of economies of scale allows financial institutions to lower transaction costs for their customers. It demonstrates how size and repetition in operations lead to more cost-effective financial service delivery.

20. (A) Deposit insurance generally offers unlimited protection to all global depositors.
Deposit insurance generally does not offer unlimited protection to all global depositors. Governments establish safety nets like deposit insurance to protect small savers who may not have the resources to evaluate a bank's creditworthiness. However, this protection is typically capped at specific limits rather than being unlimited for all global depositors. These mechanisms ensure that savers feel confident placing money in banks, maintaining financial stability even during periods of banking sector stress.

21. (C) Products with better liquidity characteristics
Banks provide financial products with better liquidity characteristics than many direct investments. For example, a depositor can prematurely close a fixed deposit to access cash for emergencies, albeit often with a small penalty. This flexibility allows individuals to meet unexpected expenditure needs without waiting for maturity. Such liquidity is a core advantage of using banking services over illiquid instruments.

22. (B) Price risk
Price risk refers to the possibility that the value of a financial instrument will decrease when an investor needs to sell it. Direct investments in corporate securities often lack the stability of bank deposits. If an individual must sell these assets during a market downturn or a medical emergency, they may receive less than the original investment. This volatility is a deterrent.

23. (D) Payment services involve making payments for customers using their bank accounts.
Payment services are a core function of the banking system, enabling the efficient transfer of funds between parties. Banks execute payments for customers using account balances to settle transactions for goods and services. This infrastructure supports daily commerce and economic stability. Unlike manufacturing management, these financial services focus on facilitating the movement of money through secure and reliable systems.

24. (D) By spreading millions of deposits across thousands of loans to minimize individual stakes.
Banks achieve diversification by pooling resources from a vast number of depositors and distributing them across many different loans. By spreading millions of deposits into thousands of separate credits, the bank ensures that no single borrower's failure can significantly harm the institution or its savers. This process minimizes individual stakes in any one asset, effectively managing firm-specific risk.

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25. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Unlike banks that perform detailed credit evaluations of their borrowers, average depositors rarely assess the financial health of their chosen bank. This information asymmetry creates a risk that depositors' funds could be lost if the institution fails. Consequently, governments provide safety nets to protect creditors. These protections are necessary because depositors generally assume their money is safe and available.

26. (D) The presence of high monitoring costs, lack of liquidity, and exposure to price risk.
Household savers often find direct investment in corporate instruments unattractive due to several significant obstacles. High monitoring costs, a lack of immediate liquidity, and exposure to price risk make direct lending difficult for individuals. Without intermediaries like banks to manage these issues, the flow of funds remains low. Financial institutions bridge this gap by offering safer, more liquid investment alternatives.

27. (A) Maturity transformation
Maturity transformation is illustrated when a bank collects short-term savings from households and provides long-term loans to businesses. Families often need liquidity for unexpected shocks, while manufacturers require decade-long funding for facilities. By bridging these different time horizons, banks enable both parties to achieve their goals. This function is vital for aligning the immediate needs of savers with industry.

28. (A) Only (I), (II), and (III)
The Parable of the Fisherman demonstrates basic economic principles like the trade-off between current consumption and investment. It also highlights how the level of available savings directly influences potential investment. Furthermore, the story introduces concepts of capital lending and interest charges. However, it does not address complex modern structures like central authority-governed monetary transmission mechanisms or formal policies.

29. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Financial intermediaries like banks operate at a large scale, allowing them to perform services at significantly reduced transaction costs. As the volume of transactions increases, the per-unit cost of activities like due diligence and documentation decreases. These economies of scale make banking services more affordable. This efficiency is a primary reason why intermediation is preferred over direct financial transactions.

30. (D) By utilizing the spread between interest received from borrowers and paid to savers.
Banks primarily generate profit through the interest rate spread. This is the difference between the interest income received from borrowers and the interest expense paid to depositors. By charging higher rates on loans than they offer on savings, banks cover their operational costs and generate revenue. This margin is essential for the sustainability of financial intermediaries during asset transformation.

31. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Adverse selection occurs when high average interest rates drive good-quality borrowers out of the market. Lenders charge a rate that compensates for potential bad debts because they cannot distinguish between risks. This penalizes low-risk borrowers, who then seek cheaper alternatives. Consequently, only high-risk borrowers remain, increasing overall credit risk. This information failure demonstrates why rigorous credit evaluation is necessary.

32. (B) Bank cash assessments and the regulatory requirements of central authorities.
The money multiplier determines the total money created through the fractional-reserve banking process. Its size depends on the amount of reserves banks must hold, which is influenced by both internal bank assessments and central bank regulations. Specifically, the required-reserve ratio dictates how much of each deposit

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must be sidelined. Lower reserve requirements generally lead to a larger money multiplier.

33. (B) Selection occurs before a transaction, while hazard occurs after a transaction is made.
Adverse selection and moral hazard are distinct information-related problems. Selection occurs before a transaction takes place, where the party most likely to cause an undesirable outcome is the one seeking the deal. Moral hazard happens after the transaction, when the borrower engages in risky activities that the lender cannot easily monitor. Both issues arise from asymmetric information between parties.

34. (A) Only (I), (II), and (III)
Financial inclusion aims to provide affordable and timely credit to vulnerable or disadvantaged social groups. It focuses on bringing these populations into the formal banking system to develop a culture of savings. This process broadens the resource base of the national financial structure. Effective inclusion strategies seek to replace exploitative informal lenders with regulated services that protect individual wealth.

35. (A) Monetary policy and aggregate demand
The monetary transmission mechanism is defined as the process through which monetary policy decisions affect the real economy. It specifically links central bank actions to aggregate demand and inflation. By influencing variables like interest rates and money supply, the mechanism impacts spending and investment levels. Understanding this link is crucial for policymakers attempting to achieve economic stability and growth.

36. (C) Only (I) and (III)
Digital transformation allows banks to offer services through electronic platforms and virtual channels. These technologies reduce operating costs by minimizing the need for expensive physical branch expansions. Customers benefit from increased convenience, while banks optimize their monitoring and transaction processes. This shift toward digitalization is a key strategy for modern financial institutions to improve efficiency and reach wider audiences.

37. (B) Savings deficit units
Households, businesses, and governments are classified as savings deficit units when their spending requirements exceed their available income. These entities rely on the financial system to obtain the necessary funds for their operations or consumption. By borrowing from the surplus generated by others, deficit units facilitate economic flow. This categorization is fundamental to understanding how financial intermediaries allocate capital.

38. (A) Only (I)
A bank's decision to lend to a firm is considered an important positive signal in financial markets because banks carefully evaluate a firm's creditworthiness before approving loans. This information influences investors and other creditors. Therefore, Statement I is correct. Statement II is incorrect because bank loans are actually a major source of funding for many firms and often require renewal or monitoring. Hence, evaluating the borrower's financial strength and repayment capacity is essential in bank credit allocation.

39. (D) Creation of money via the multiplier effect
The process described illustrates the money multiplier effect in the banking system. When Bank Sigma receives a deposit, it keeps the required reserve of 10% and lends the remaining amount. The loan is then deposited into another bank, which again keeps a fraction as reserves and lends the rest. This cycle continues across banks, increasing the total money supply in the economy. Therefore, the phenomenon is known as creation of money through the multiplier effect.

40. (D) Moral hazard
Moral hazard arises when a borrower changes their behavior after receiving a loan, engaging in activities that increase risk for the lender. In this scenario, using business funds for speculative day-trading represents a significant deviation from agreed-upon terms. Because the bank cannot perfectly monitor the entrepreneur's actions post-disbursement, it faces potential losses. This highlights the importance of ongoing monitoring.

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41. (B) The COVID-19 pandemic
The COVID-19 pandemic acted as a major catalyst for the rapid digitalization of financial services. Movement restrictions forced banks to scale up virtual infrastructures so customers could conduct transactions without visiting physical branches. This period saw a significant shift toward digital payments and remote account management. The pandemic essentially accelerated existing trends in electronic banking for most global consumers.

42. (C) Adverse selection
The "market for lemons" scenario illustrates how asymmetric information leads to adverse selection. When buyers cannot distinguish between high-quality and low-quality goods, they only offer an average price. This drives sellers of superior products out of the market, leaving only inferior options available. In financial markets, this phenomenon forces lenders to charge higher rates, potentially excluding good quality borrowers.

43. (B) Providing a valuable signal through credit allocation
When a major bank approves a credit line after rigorous due diligence, it provides a valuable signal to other market participants. Suppliers and investors interpret this approval as a validation of the firm's financial health. This reduced information asymmetry often leads to better trade terms and increased investment interest. Banks thus play a critical role as primary information producers.

44. (D) (I), (II), (III), and (IV)
Monetary policy influences the real sector through several distinct transmission channels. These include the quantum channel, which focuses on money supply and credit volume, and the interest rate channel. Additionally, the exchange rate channel impacts open economies, while the asset price channel affects wealth and spending. Together, these conduits represent how central bank decisions reach domestic manufacturing.

45. (A) P-3, Q-1, R-4, S-2
Digital transformation in banking involves several components, such as electronic platforms like e-banking and new service points like POS terminals. These technologies save time and reduce operating costs for institutions. Furthermore, global events like the COVID-19 pandemic significantly accelerated the adoption of these financial transactions. Matching these attributes helps identify how modern technology reshapes the delivery of services.

46. (B) Asymmetric information
Asymmetric information is an information failure where one party in an economic transaction has more material knowledge than the other. In financial markets, borrowers typically know more about their own risks and intentions than lenders. This imbalance creates problems like adverse selection and moral hazard. Intermediaries like banks work to bridge this gap through specialized data collection processes.

47. (B) Digitalization of the payment system has completely eliminated all cyber risks for new technology users.
Digitalization of the payment system has not eliminated all cyber risks for new technology users. Payment services act as the circulatory system of the economy, keeping money moving through secure clearing and transfer systems. While digitalization has improved efficiency, it has not eliminated all risks. New technologies introduce cyber threats that users and institutions must manage. Any breakdown in these systems can lead to gridlock, causing significant harm to daily commerce and stability.

48. (B) Hazard arises when borrowers engage in activities undesirable to the lender.
Moral hazard describes the risk that a borrower will engage in activities undesirable to the lender after a transaction is completed. It occurs because the lender cannot perfectly observe or control the borrower's actions post-loan disbursement. Lenders must implement monitoring strategies to ensure funds are used as intended and to minimize the likelihood of default arising from information asymmetry.

49. (A) 2-4-1-3
The money multiplier process begins with an initial deposit in a commercial bank. The bank retains the required reserve and lends the

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remaining funds to a borrower. This lent money eventually returns to the banking system as a new deposit in another institution. As this relending cycle repeats multiple times across various banks, the total money supply expands significantly.

50. (C) Traditional monetary transmission mechanism
Traditional monetary transmission occurs when central bank policy changes lead to shifts in commercial bank lending rates. Lower interest rates reduce borrowing costs for manufacturers, encouraging them to expand operations and increase physical investments. This sequence demonstrates how financial intermediaries serve as the conduit for national economic policy. It highlights the link between monetary decisions and real sector activity.

51. (D) Digital banking and inclusive banking
Banks achieve financial inclusion and operational efficiency by deploying digital tools like e-banking apps and POS terminals in remote areas. This strategy provides marginalized populations with full banking access without the high cost of physical branches. By reducing overheads while expanding service reach, banks demonstrate the synergy between digital transformation and inclusive growth for disadvantaged economic groups.

52. (D) George A. Akerlof
George A. Akerlof authored the influential 1970 paper titled "The Market for 'Lemons'". This work explored how asymmetric information can lead to market failure, using the used-car market as a primary example. His findings showed that when quality cannot be easily distinguished, only low-quality goods remain. This framework is fundamental to understanding adverse selection in credit markets.

53. (A) P-3, Q-4, R-2, S-1
Different transmission channels relate to specific economic variables. The quantum channel is linked to money supply and credit volume, while the interest rate channel incorporates money supply and interest costs. Open economy dynamics are captured by the exchange rate channel. Finally, the asset price channel relates to the valuation of financial assets. These relationships define how monetary policy works.

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54. (C) Clearing and transfer of funds
The clearing and transfer of funds are two critical payment services provided by the banking system. These functions allow money to move securely between different accounts and institutions to settle transactions. Efficient payment infrastructure is essential for the smooth operation of the modern economy. By facilitating these transfers, banks prevent gridlock and ensure that financial obligations are met.

55. (A) Banks are specialists in establishing and continually reevaluating firm creditworthiness.
A bank's willingness to lend acts as a valuable signal because banks are specialists in measuring and managing credit risk. They possess the expertise to conduct deep due diligence and continually reevaluate a borrower's financial health. This specialized knowledge allows them to distinguish good prospects from bad ones more effectively than general investors. Bank approval serves as a quality proxy.

56. (A) P-4, Q-3, R-1, S-2
Asymmetric information is an information failure where parties have unequal knowledge. Adverse selection is a pre-transaction problem where high-risk borrowers are most likely to seek loans. Moral hazard involves post-transaction risks where borrowers take undesirable actions. Risk sharing allows intermediaries to sell products with comfortable characteristics while holding riskier assets. Matching these definitions is essential for understanding financial intermediation.

57. (A) It brings low-income groups into the formal banking sector, helping to protect their wealth in times of crisis.
Financial inclusion brings low-income and disadvantaged groups into the formal banking sector. This integration helps protect their wealth during economic crises by providing safe savings options and regulated credit. It reduces reliance on exploitative informal lenders and broadens the financial system's resource base. Ultimately, inclusion ensures that all social

segments have access to affordable, reliable financial services.

58. (A) Completely eliminating all risk sharing mechanisms
Utilizing risk sharing mechanisms. Banks mitigate adverse selection through various methods like rigorous due diligence, information gathering, and collateral management policies. These actions help lenders distinguish between high-risk and low-risk borrowers before a transaction occurs. Risk sharing mechanisms are also fundamental tools for managing these challenges. Completely eliminating risk sharing would be counterproductive, as it is a core strategy for managing uncertainties.

59. (B) Only (I), (II), IV, and (V)
In a fractional-reserve system, banks expand the money supply by lending out a portion of their deposits. This process increases total bank deposits across the economy, creating more money than was initially deposited. The required-reserves ratio sets the minimum amount banks must keep, limiting but not stopping this expansion. Consequently, the banking system can grow the money supply significantly.

60. (B) The transmission channels function entirely independently and are mutually exclusive of one another.
The transmission channels do not function entirely independently and are not mutually exclusive of one another. Instead, they often overlap and depend on the economy's development stage and financial structure. For instance, in bank-heavy economies, the credit channel is particularly prominent. These pathways function together to translate policy decisions into changes in aggregate demand.

61. (C) Only (I) and (III)
Asset transformation is the conversion of bank liabilities into assets with different characteristics, such as turning liquid deposits into long-term loans. Additionally, the monetary transmission mechanism links policy decisions to aggregate demand. While banks diversify portfolios to reduce risk, they do not achieve this by concentrating only on one area. Spreading investments across various sectors is the key.

62. (A) Immediate elimination of the money multiplier effect
If banks fail to measure and manage financial risks, it can lead to a global breakdown in credit markets and a loss of public confidence. Such failures threaten overall financial stability and can trigger widespread economic crises. While the money multiplier is a separate mechanic of fractional reserves, the loss of trust would disrupt the entire system. Risk management is essential.

63. (C) An asset that can be transformed into money quickly, easily, and at a low transaction cost.
A highly liquid asset is one that can be converted into money quickly and easily without a significant loss of value. Such assets typically feature low transaction costs and minimal price risk. Financial intermediaries provide these products to savers, allowing them to access cash almost instantly for immediate needs. This stands in contrast to illiquid assets that take time.

64. (A) Only (I), (III), (IV), and (V)
Banks are special because they mobilize surplus funds, manage information asymmetries, and provide critical payment infrastructure. They address adverse selection and moral hazard through due diligence and monitoring. Furthermore, they act as the medium through which national monetary policy becomes reality. By reaping economies of scale, they provide these services at a lower cost than direct transactions.

65. (A) P-3, Q-2, R-4, S-1
Dealing with borrowers directly involves high monitoring, liquidity, and price risks for individuals. Financial intermediaries resolve this by paying interest to savers and charging it to borrowers. The process of asset transformation often leads to mismatches in maturities and interest rate re-pricing. However, maintaining a diversified portfolio helps banks mitigate various risks. These mechanics explain financial intermediation complexities.

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66. (D) Provider of liquidity
Using an ATM for an instant cash withdrawal is a practical demonstration of a bank's role in providing liquidity. Banks offer products that allow depositors to convert their electronic balances into physical currency immediately. This service ensures that individuals can meet urgent payment needs at any time. The ability to access funds on demand is a fundamental banking benefit.

67. (D) Asset transformation function — Refers strictly to converting physical assets to monetary assets.
Asset transformation function — Does not refer strictly to converting physical assets to monetary assets. Asset transformation specifically refers to the process of converting bank liabilities, such as deposits, into bank assets, such as loans. These two sides of the balance sheet typically have divergent characteristics in terms of maturity and liquidity. It does not refer to the conversion of physical objects into monetary assets. Understanding this distinction is vital for intermediate finance.

68. (A) Maturity Mismatch — A state where short-term assets and short-term liabilities perfectly align in time.
Maturity Mismatch — A state where short-term assets and short-term liabilities do not perfectly align in time. Maturity mismatch occurs when the time horizons of a bank's assets and liabilities do not align. Typically, banks hold short-term liabilities like deposits and long-term assets like loans. This state is not one of perfect alignment but rather a fundamental characteristic of maturity transformation. It creates liquidity and interest rate risks that banks must carefully manage to maintain stability.

69. (B) Avoiding all credit risk assessments to maximize the total number of new loans approved for clients.
Conducting credit risk assessments for all new loans approved for clients. Banks must act as specialists in measuring and managing financial risks to maintain stability. An incorrect approach would involve avoiding credit risk assessments just to increase the volume of loan approvals. Such negligence would ignore the problems of adverse selection and moral hazard, leading to potential institutional failure. Effective risk management requires rigorous due diligence and continuous borrower monitoring.

70. (A) P-3, Q-2, R-1, S-4
Transaction costs refer to resources spent on due diligence, while the creation of money relates to expanding the supply via the multiplier effect. Moral hazard is the risk of undesirable post-transaction behavior by borrowers. Digitization enables modern service channels like virtual and e-banking. Matching these keywords to their correct contexts provides an overview of the banking sector's various functions.

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CHAPTER 02
Risks and Risk Management in Banks

May/June 2010

1. Identify the INCORRECT statement regarding financial and non-financial risks in banking.
(A) Financial risks inflict loss on a bank directly, while non-financial risks affect the financial condition indirectly.
(B) Market risk, operational risk, and liquidity risk are examples of financial risks.
(C) Control risk, reputation risk, and legal risk are considered non-financial risks.
(D) The impact of non-financial risks can generally be measured quantitatively with precise ease.

Oct/Nov 2023

2. Statutory Liquidity Ratio (SLR) refers to the reserves that banks must keep in the form of government bonds or approved securities. It is calculated as a percentage of which of the following?
(A) Gross Time and Demand Liabilities
(B) Total risk-weighted assets of the bank
(C) Net Demand and Time Liabilities (NDTL)
(D) Total deposit base excluding foreign currency deposits

May/June 2018

3. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R).
Assertion (A): The mathematical expression for measuring banking risk incorporates both likelihood and consequences, represented as Risk = Probability × Impact.
Reason (R): Risk is concerned not just with the probability of an event happening, but also with the consequence of that event in terms of lost money.
In the light of these two statements, choose the most appropriate answer from the options given below:
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2014

4. Consider the following statements regarding the outcomes of the Pradhan Mantri Jan Dhan Yojana (PMJDY) as a financial inclusion trend:
I Over 42 crore new accounts have been opened since its inception.
II 55.40% of Jan Dhan account holders are women.
III 65.99% of Jan Dhan accounts are located in rural and semi-urban areas.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

May/June 2025

5. A developing nation establishes a robust, sound, and well-regulated financial system over a decade. Consequently, several multinational corporations are attracted to invest heavily in the country. In the context of financial interconnections, what does this scenario best illustrate?
(A) Financial Contagion
(B) Positive Externality
(C) Negative Externality
(D) Sovereign Immunity

Oct/Nov 2007

6. The provisions relating to the Corporate Insolvency Resolution Process (CIRP) under the Indian Bankruptcy Code (IBC) formally came into force on which date?

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(A) May 2016
(B) December 1, 2016
(C) March 2017
(D) April 1, 2021

May/June 2021

7. In the context of modern risk theory, how is "risk" most commonly defined within organizational and business processes?
(A) The absolute certainty of an adverse event occurring within a specific business environment
(B) A deviation from the optimum solution, usually expressed in terms of expected loss
(C) The guarantee of financial returns matching the initially expected project returns
(D) The unpredictable outcome of purely operational failures within a business entity

Oct/Nov 2016

8. Consider the following factors regarding the Indian balance-of-payment crisis in 1991:
I A rise in oil prices and a sharp decline in exports at the start of the Gulf War.
II Foreign exchange reserves dropping to less than the cost of two weeks' imports.
III A highly outward-looking economic policy combined with an overreliance on foreign direct investment.
IV Gold reserves having to be flown to London as collateral for loans.
Which of the above statements were contributing factors to the crisis?
(A) (I), (II), and (III) only
(B) (I), (II), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

May/June 2005

9. Consider the following specific requirements issued by the RBI in 1993 for setting up new private sector banks:
I Maintain paid-up capital of at least 1 billion.
II List shares on stock exchanges.
III Fulfil priority sector credit requirements.
IV Ensure a ceiling of five percent of total voting rights held by a single foreign shareholder.
V Not to set up a subsidiary or mutual funds for at least three years.
Which of the above statements were specific requirements issued?
(A) (I), (II), (III), and (IV)
(B) (I), (II), (III), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

Oct/Nov 2020

10. All of the following are examples of non-financial risks faced by a bank, EXCEPT:
(A) Strategic Risk
(B) Compliance Risk
(C) Credit Risk
(D) Reputation Risk

May/June 2013

11. Which of the following is the most appropriate driver propelling the continued expansion of banking regulations post the global financial crisis?
(A) The rising public appetite for bailing out banks using taxpayers' money
(B) The increasing tolerance of governments toward financial crimes and tax avoidance
(C) The shift from macro-prudential regulation back to an exclusive focus on micro-prudential regulation
(D) The demand by governments for global compliance, ensuring "good banks" across borders

Oct/Nov 2011

12. Match the risk categories in List I with their corresponding definitions in List II based on the Risk and Known Unknown Matrix.
List I: (Risk Category)
P. Known Knowns
Q. Known Unknowns
R. Unknown Knowns
S. Unknown Unknowns
List II: (Definition)
1. Things we understand but we cannot measure
2. Things we are neither aware of nor we can measure
3. Risks we are aware of but cannot measure
4. Risks we are aware of and can measure
(A) P-3, Q-4, R-2, S-1
(B) P-1, Q-2, R-4, S-3
(C) P-4, Q-3, R-1, S-2
(D) P-2, Q-1, R-3, S-4

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May/June 2024

13. Identify the INCORRECT pair regarding statutory pre-emptions in the Indian banking system.
(A) Maximum legal limit of CRR by 1991 — 15%
(B) Peak level of SLR in February 1992 — 38.5%
(C) Statutory minimum level of SLR at present — 18%
(D) CRR rate as of October 2021 — 9%

Oct/Nov 2009

14. Consider the following statements regarding the developments related to increased market volatility since the 1970s:
I The collapse of the Bretton Woods Agreement led to free-floating exchange rates, causing significant currency risk for importers and exporters.
II The deregulation of interest rates and rising inflation resulted in highly predictable borrowing costs and lending rates.
III Extreme price movements in crude oil exposed producer and consumer countries to vicious price risk, leading to the use of hedging tools.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

May/June 2017

15. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R).
Assertion (A): Following bank consolidation, a larger bank might command a higher credit rating than a smaller bank.
Reason (R): A larger bank generally has a more diversified portfolio, which results in less volatility in its earnings.
In the light of these two statements, choose the most appropriate answer from the options given below:
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2022

16. According to the distinction formalized by economist Frank Knight, which of the following accurately differentiates "risk" from "uncertainty"?
(A) Risk involves known or inferred probabilities, while uncertainty involves unknown probabilities
(B) Risk and uncertainty are synonymous concepts representing a state of total ignorance
(C) Uncertainty is easily converted into certainty, while risk is not susceptible to measurement
(D) Risk refers to unforeseen future events, while uncertainty refers to historical deviations

May/June 2008

17. Identify the CORRECT pair regarding banking supervision enhancements by the RBI.
(A) CAMEL framework adoption — 1999-2000
(B) Board of Financial Supervision (BFS) — Established in 1991
(C) Shift in supervisory role — From macro-management to micro-regulation
(D) Basis of CAMEL rating — Credit, Assets, Market, Earnings, Liabilities

Oct/Nov 2015

18. Consider the following statements regarding the interconnectedness among banking risks:
I An adverse movement in forex rates can increase the bank's exposure to a customer, thereby giving rise to increased default risk.
II An effective mitigation strategy against market risk may eventually transform into credit risk at a later point in time.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

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May/June 2012

19. A commercial bank wishes to set interest rates for loans under ₹200,000 freely to attract more retail customers. According to the deregulation guidelines issued in April 1998, what condition must the bank fulfill to implement this pricing strategy?
(A) The rate must be mandated exclusively by the RBI.
(B) The rate must exceed the cost of funds plus a 5% fixed premium.
(C) The bank must cross-subsidize the loans with postal savings rates.
(D) The rate must not exceed the bank's prime lending rate (PLR).

Oct/Nov 2025

20. The main trigger for the sweeping banking sector reforms initiated in India in 1991 was a severe balance-of-payment crisis. During the 1980s, India's fiscal deficit had increased to what percentage of its GNP?
(A) 4.5% to 6%
(B) 6% to 8.4%
(C) 9% to 15%
(D) 18% to 25%

May/June 2006

21. Consider the following statements regarding the Corporate Insolvency Resolution Process (CIRP):
I The IBC aimed at insolvency resolution in a time-bound manner of 180 days.
II This 180-day period is extendable by another 90-days under certain circumstances.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2018

22. A commercial bank implements a credit risk strategy with a projected Net NPA ratio of 3%. However, due to complacency among the monitoring staff and reckless sanctioning with insufficient collateral, the Net NPA ratio escalates to 8%. Which type of risk is predominantly illustrated in this scenario?
(A) Business Risk
(B) Control Risk
(C) Financial Risk
(D) Reputation Risk

May/June 2019

23. Arrange the spread of the financial contagion that began in July 1997 in the correct chronological order:
I Brazil
II East Asia
III Russia
IV Thailand
(A) (IV), (II), (III), (I)
(B) (IV), (III), (II), (I)
(C) (II), (IV), (I), (III)
(D) (III), (IV), (I), (II)

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Oct/Nov 2012

24. Following the recommendations of the Narasimham Committee, when was the Basel Accord Capital Standards adopted in India, raising the regulatory minimum capital adequacy ratio to 9%?
(A) April 1992
(B) October 1994
(C) April 1998
(D) June 2003

May/June 2022

25. What was the most appropriate overarching objective of the banking sector reforms recommended by the Narasimham Committee in 1991?
(A) To nationalize all private sector banks to ensure absolute financial stability
(B) To liberalize the sector through deregulation and improving overall financial soundness
(C) To increase statutory pre-emptions to force banks to hold more government securities
(D) To set fixed interest rates for all deposits to eliminate market competition

Oct/Nov 2010

26. In the "Risk and Known Unknown Matrix", what do "Unknown Unknowns" represent?
(A) Risks that are properly identified and measured by the financial institution
(B) Weaknesses in a model which the risk manager identifies but fails to measure
(C) Variables we understand conceptually but cannot quantify through measurement
(D) Things we are neither aware of nor able to

measure, such as Knightian uncertainty

May/June 2009

27. A daily wage earner visits a bank branch to open a new savings account under the relaxed KYC norms meant to facilitate financial inclusion. To keep the account operational without full KYC documentation, what is the maximum permitted balance and maximum aggregate credits in a year?

(A) Balance not exceeding ₹50,000 and aggregate credits not exceeding ₹1 lakh a year.
(B) Balance not exceeding ₹1,00,000 and aggregate credits not exceeding ₹2 lakh a year.
(C) Balance not exceeding ₹20,000 and aggregate credits not exceeding ₹50,000 a year.
(D) Balance not exceeding ₹2,00,000 and aggregate credits not exceeding ₹5 lakh a year.

Oct/Nov 2024

28. When consuming or producing goods causes a cost to a third party not directly related to the transaction, such as an unstable financial system resulting in flight of capital from a country, it is best described conceptually as:

(A) A negative externality
(B) A positive externality
(C) Financial contagion
(D) Market manipulation

May/June 2015

29. Arrange the following events related to the deregulation of deposit interest rates in India in the correct chronological order:

I Interest rates for term deposits up to two years were liberalized.
II Overall maximum rate for term deposits was fixed.
III Minimum maturity of term deposits was lowered to 15 days.
IV Interest rate on SB (Savings Bank) accounts was deregulated.

(A) (II), (I), (III), (IV)
(B) (I), (II), (III), (IV)
(C) (II), (III), (I), (IV)
(D) (I), (III), (II), (IV)

NODIA

Oct/Nov 2008

30. Identify the CORRECT statement regarding the globalization of financial markets.

(A) It has limited the availability of capital and isolated domestic financial systems.
(B) It has made funding significantly more difficult to obtain from a wide range of resources.
(C) It completely eliminated the likelihood of financial imbalances and the contagion effect across borders.
(D) It helped in smoothing out the effects of domestic shocks by enabling risk-sharing and diversification.

May/June 2023

31. Credit risk is defined as the potential loss a bank would suffer due to which of the following events?

(A) The adverse movement in the market value of a trading portfolio
(B) The inability of a bank to meet its cash and collateral obligations when they come due
(C) A borrower or counterparty failing to meet its financial obligations in accordance with agreed terms
(D) Inadequate or failed internal processes, people, and systems

Oct/Nov 2019

32. A bank has more interest-sensitive liabilities than interest-sensitive assets, resulting in a Negative Gap. If there is an upward movement in the market interest rate, what will conceptually happen to the bank?

(A) The net interest earnings of the bank will increase substantially.
(B) The net interest earnings of the bank will suffer a decline due to Repricing Risk.
(C) The bank will experience an immediate Yield Curve flattening.
(D) The bank will face zero basis risk as the gap is perfectly matched.

May/June 2007

33. Consider the following statements regarding the role of Technology and Analytics as a "Risk Muscle":

I Big data enables banks to leverage granular customer-payment and online-browsing activity in risk decision making.

II Machine learning identifies complex, nonlinear patterns in large data sets.
III Machine learning models degrade over time as they acquire new information.
IV Machine learning is expected to be applied in early-warning systems and financial-crime detection.

Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (I), (II), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

Oct/Nov 2017

34. Identify the CORRECT pair regarding market risks.
(A) Foreign Exchange Risk — Risk of losses due to lack of buyer interest in physical commodities
(B) Conversion Risk — The risk that a bond issuer defaults before final settlement
(C) Unsystematic Equity Risk — Risk related to general macroeconomic industry forces
(D) Commodity Price Risk — Risk of financial losses caused by changes in prices for buyers and producers

May/June 2011

35. Identify the INCORRECT statement regarding the indications of sovereign default associated with Country Risk.
(A) Liquidity restriction — Failure to pay due to domestic currency conversion curbs
(B) Actual default — The physical inability of the country to meet its debt obligations
(C) Political default — A unilateral decision by a government to default for political reasons
(D) Restructuring — The rolling over of sovereign debt due to a fragile financial system

Oct/Nov 2006

36. Match the non-financial and secondary risks in List I with their respective consequences in List II.
List I: (Risk Type)
P. Model Risk
Q. Liquidity Risk
R. Legal Risk
S. Reputation Risk

List II: (Consequence)
1. Inability to meet cash and collateral obligations when they come due
2. Contracts becoming unenforceable due to deficient documentation
3. Adverse consequences from decisions based on incorrect mathematical outputs
4. Loss arising from negative public opinion hindering relationship establishment

(A) P-3, Q-1, R-2, S-4
(B) P-1, Q-3, R-4, S-2
(C) P-2, Q-4, R-1, S-3
(D) P-4, Q-2, R-3, S-1

May/June 2014

37. Identify the CORRECT statement regarding the evolving supervisory oversight and compliance trends in banks.
(A) "Principles-based compliance" involves asking if practices are "fair" from a customer's perspective.
(B) Compliance with existing rules is deemed highly sufficient to protect banks against future repercussions.
(C) Automated compliance aims to increase human interventions in dealings with customers to ensure accuracy.
(D) Regulatory preparedness is an afterthought implemented only once businesses have launched a new product.

Oct/Nov 2021

38. Market risk is formally defined as:
(A) The potential loss arising from a bank's inability to liquidate its assets quickly
(B) The uncertainty of legal outcomes stemming from defective market or trading contracts
(C) The potential consequences from decisions based on incorrect mathematical model outputs
(D) The risk of loss arising from adverse movements in the value of trading portfolios

May/June 2020

39. Match the components of Optionality Risk in List I with their appropriate examples or descriptions in List II.
List I: (Component)
P. Embedded option on Liability side
Q. Embedded option on Asset side

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R. Automatic option risk
S. Behavioral option risk
List II: (Example/Description)
1. Exchange-traded interest rate option contracts
2. Right of early withdrawal on customer deposits
3. Mortgage prepayments utilized by homeowners
4. Transactions where rate changes alter client conduct

(A) P-3, Q-2, R-4, S-1
(B) P-1, Q-4, R-2, S-3
(C) P-4, Q-1, R-3, S-2
(D) P-2, Q-3, R-1, S-4

Oct/Nov 2013

40. A bank holds an investment in corporate bonds. Before any actual default occurs, the issuer's credit rating is downgraded by a rating agency. Consequently, the market interest rate for these bonds goes up, triggering a decline in the aggregated present value of the promised cash flow. Which specific risk has materialized?
(A) Default Risk
(B) Settlement Risk
(C) Country Risk
(D) Migration Risk

May/June 2016

41. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R).
Assertion (A): Maintaining too much liquid assets may adversely impact the long-term profitability of a bank.
Reason (R): Liquid assets are typically less profitable compared to long-term loan assets.
In the light of these two statements, choose the most appropriate answer from the options given below:
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2005

42. Model errors in risk management stem from multiple issues. Which of the following is NOT typically considered a source of model error?
(A) Significant issues relating to the data quality and availability
(B) Technical or implementation errors within the model's framework
(C) The automated instant decisioning for loan disbursements
(D) Unforeseen correlation or time inconsistencies in the data

May/June 2018

43. A bank funds its assets using instruments where the rate of interest paid on liabilities increases before the rate of interest received on assets does, due to differences in the timing of rate changes. Which specific type of interest rate risk has the bank encountered?
(A) Optionality Risk
(B) GAP Risk
(C) Basis Risk
(D) Yield Curve Risk

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Oct/Nov 2011

44. Two financial institutions enter into an OTC interest rate swap derivative contract. The future value of this contract can be positive or negative depending on market rate movements, meaning either party could suffer a loss if the other fails to fulfill its part of the obligation before final settlement. What specific type of risk is described here?
(A) Unilateral Credit Risk
(B) Sovereign Credit Risk
(C) GAP Risk
(D) Counterparty Credit Risk

May/June 2025

45. The scope of "Process risk" under operational risk includes all of the following EXCEPT:
(A) Inadequate procedures on processing information, such as errors in booking transactions.
(B) Organizational deficiencies.
(C) Model errors and the absence of adequate tools for measuring risks.
(D) The technical deficiencies of the information system or the risk measures.

Oct/Nov 2023

46. A commercial bank is upgrading its technology to meet changing customer expectations. It plans to offer rapid real-time answers for loan applications using processes where requested data is pre-populated from public sources. Which specific strategic priority does this scenario best represent?
(A) "Segment of one"
(B) Automated instant decisions
(C) Financial contagion isolation
(D) Principles-based compliance

May/June 2022

47. Identify the INCORRECT statement regarding Equity Price Risk.
(A) It is the risk of a decline in the value of a security or a portfolio due to stock price volatility.
(B) Unsystematic risk pertains to a certain firm and can be mitigated through diversification.
(C) Systematic risk pertains to a certain firm and can be successfully mitigated through diversification.
(D) It is driven by mainly two types of factors: systematic and unsystematic risk.

Oct/Nov 2014

48. Match the sub-categories of Credit Risk in List I with their respective definitions in List II.
List I: (Sub-category)
P. Default Risk
Q. Migration Risk
R. Recovery Risk
S. Settlement Risk
List II: (Definition)
1. Down-gradation of credit rating indicating deterioration of credit quality
2. Arises when payments are not exchanged simultaneously in transactions
3. Amount of loss suffered by a bank after all default recoveries are made
4. Risk that a borrower will fail to repay its debt on time
(A) P-1, Q-4, R-2, S-3
(B) P-4, Q-1, R-3, S-2
(C) P-3, Q-2, R-4, S-1
(D) P-2, Q-3, R-1, S-4

May/June 2021

49. A bank prices its floating-rate loans based on the 364-day T-Bill rate, whereas its liabilities are priced based on the 1-year Certificate of Deposit (CD) rate. During a policy adjustment, the CD rate rises by 50 bps while the T-Bill rate remains stagnant. The bank's net interest income drops. Which risk does the bank face due to this imperfect correlation?
(A) Basis Risk
(B) Repricing Risk
(C) Automatic Option Risk
(D) Yield Curve Risk

Oct/Nov 2010

50. Consider the following statements regarding the findings of the 2021 BoC-BoE Sovereign Default Database:
I Since 1960, two-thirds of the current universe of 215 sovereigns have defaulted on their obligations.
II Total sovereign debt in default decreased by 48 percent in 2020.
III A first-time default on foreign currency bonds was recorded by Lebanon.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2005

51. A bank's management team relies extensively on newly developed quantitative algorithms for underwriting retail credits. Due to a fundamental coding error that is inconsistent with the design objective, the algorithm miscalculates credit scores, leading to widespread sanctioning of bad loans and a severe financial loss. This is a classic example of:
(A) Technology Risk
(B) Contagion Risk
(C) Liquidity Risk
(D) Model Risk

Oct/Nov 2020

52. A major bank experiences a severe breach of its secure network by external hackers, leading to the compromise of confidential customer data and massive disruption of daily operations.

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Under which broad category of risk must this cyber attack be managed?
(A) Market Risk
(B) Credit Risk
(C) Liquidity Risk
(D) Operational Risk

May/June 2013

53. Which of the following represents the most appropriate technological mitigation strategies implemented in India to address Settlement Risk?
(A) The use of collateral seizure, debt rolling, and guarantor enforcement
(B) Standard margin calls, withdrawal penalties, and automatic option triggers
(C) Delivery versus Payment (DvP), CCP clearinghouses, and PvP mechanisms
(D) Machine learning underwriting, big data tools, and automated KYC systems

Oct/Nov 2016

54. A bank aggressively funds long-term assets with short-term liabilities. The market experiences a shift where the relationship among interest rates of different maturities changes, causing the slope to flatten. This drastically amplifies the bank's maturity mismatch effect, leading to a severe decline in Net Interest Margin (NIM). Which risk is the bank suffering from?
(A) Sovereign Risk
(B) Foreign Exchange Risk
(C) Yield Curve Risk
(D) Equity Price Risk

May/June 2024

55. Identify the CORRECT statement differentiating interest rate risk in the trading book versus the banking book.
(A) In the trading book, it refers to the risk of loss in the values of fixed income securities caused by adverse changes in interest rates.
(B) In the trading book, it refers to potential loss in assets, liabilities, and capital due to rate changes, while in the banking book, it refers strictly to fixed income securities loss.
(C) The banking book interest rate risk only affects the off-balance sheet items and has no impact on net interest income.
(D) There is no differentiation; interest rate risk affects both books with identical mechanisms and identical duration horizons.

Oct/Nov 2009

56. Identify the INCORRECT statement regarding Contagion Risk management.
(A) Central banks are the only entities that need to worry about and track contagion risk.
(B) Negative market developments can spread quickly based on international capital flows and globalization.
(C) A bank's exposure to contagion risk is a main underlying driver for its classification as a global systemically important bank (G-SIB).
(D) Whether a bank is classified as a D-SIB or not, risks should be managed as if it falls within the category.

May/June 2017

57. Consider the following events that potentially trigger Operational Risk:
I People (human errors, lack of expertise, fraud)
II Processes (inadequate reporting and monitoring procedures)
III Technical (model errors, implementation flaws)
IV Technology (deficiencies of the information system and system failure)
V External events
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (IV) only
(B) (I), (II), (IV), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2022

58. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R).
Assertion (A): An exposure with high recovery risk tends to cause a higher loss to the bank.
Reason (R): Recovery risk follows a default event, and the economic amount of recoveries is fundamentally subject to uncertainty.
In the light of these two statements, choose the most appropriate answer from the options given below:

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(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2008

59. Consider the following statements regarding Optionality Risk:

I It arises from adverse price movements in instruments that respond automatically or via behavioral changes to interest rate shifts.
II Automatic option risk includes exchange-traded and over-the-counter interest rate option contracts.
III In an automatic option, the option seller faces limited downside risk and unlimited upside reward.
IV Behavioral option risk involves transactions where changes in interest rates cause behavioral changes in the client.

Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), and (III) only

Oct/Nov 2015

60. Consider the following statements contrasting credit risk and counterparty credit risk:

I Credit risk is unilateral by nature, as the borrower does not face credit risk because of the liquidation of the bank.
II Counterparty credit risk is bilateral because the value of a derivative contract can be positive or negative for either party in the future.

Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2012

61. A bank decides to rely heavily on an intensive door-to-door deposit marketing strategy. Within two years, advancements in technology make internet-driven banking overwhelmingly popular among consumers. The bank's door-to-door strategy proves extraordinarily costly and superfluous, leading to failure in achieving its deposit goals. What type of risk has the bank failed to mitigate?
(A) Compliance Risk
(B) Contagion Risk
(C) Business Risk
(D) GAP Risk

Oct/Nov 2025

62. Which type of risk exposes the institution to civil money penalties and voiding of contracts, and is conceptually often overlooked because it blends deeply into operational risk and transaction processing?
(A) Compliance Risk
(B) Solvency Risk
(C) Liquidity Risk
(D) Yield Curve Risk

May/June 2006

63. A domestic bank engages in complex cross-border derivative transactions. After a market shock, the foreign counterparty defaults. The bank attempts to seize the collateral, but discovers that jurisdictional ambiguities and deficient documentation make the charge invalid and the contract unenforceable. What specific risk has the bank suffered?
(A) Model Risk
(B) Climate-Related Risk
(C) Legal Risk
(D) Reputation Risk

Oct/Nov 2018

64. Identify the CORRECT statement differentiating Business Risk from Strategic Risk.
(A) Business risk is purely financial, whereas strategic risk is strictly related to daily operations.
(B) Business risk evaluates external factors, while strategic risk involves unexpected changes in currency rates.
(C) Business risk concerns product markets and innovation, while strategic risk involves

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organizational goals and implementation.
(D) Strategic risk evaluates technological obsolescence, while business risk focuses on the bank's franchise value.

May/June 2019

65. Match the specific risks associated with the breakdown of Payment and Settlement Systems in List I with their descriptions in List II.
List I: (Risk Type)
P. Liquidity risk
Q. Legal risk
R. Operational risk
S. Systemic risk
List II: (Description)
1. Technical malfunctions or operational mistakes causing or exacerbating credit risks
2. Inability of a participant causing widespread liquidity or credit problems that threaten financial stability
3. Participant having insufficient funds to meet financial obligations within the system when due
4. Poor legal framework or uncertainties causing or exacerbating credit or liquidity risks
(A) P-4, Q-3, R-2, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-1, Q-2, R-4, S-3
(D) P-2, Q-1, R-3, S-4

Oct/Nov 2012

66. Which of the following represents the most appropriate description of Solvency Risk?
(A) The risk to earnings arising from the violations of institutional ethical standards
(B) The risk of financial loss resulting from inadequate or failed internal banking processes
(C) The potential loss arising from exposure of a portfolio to changes in the yield curve
(D) The risk of being unable to absorb losses with the bank's available capital

May/June 2015

67. A bank's board outlines an aggressive expansion plan without adequate communication channels or properly trained managerial capacity. Because the intangible resources deployed are deeply incompatible with the organizational goals, the implementation fails, severely impacting the bank's franchise value. Which risk does this scenario strictly depict?
(A) Credit Recovery Risk
(B) Optionality Risk
(C) Systemic Risk
(D) Strategic Risk

Oct/Nov 2008

68. A breakdown in safe, secure, and efficient payment systems gives rise to multiple dependent risks. These include all of the following EXCEPT:
(A) Credit risk
(B) Repricing risk
(C) Liquidity risk
(D) Systemic risk

May/June 2023

69. Consider the following statements regarding the mechanisms and impacts of Climate-Related Risk on banks:
I Banks are exposed to climate change through macro- and microeconomic transmission channels.
II Physical climate risk drivers result in economic costs and financial losses due to increasing severity and frequency.
III Transition risk drivers arise through changes in government policies, technological developments, or investor sentiment to reduce GHG emissions.
IV Credit risk increases if climate risk drivers reduce borrowers' ability to repay and service debt, known as the income effect.
V Banks' ability to fully recover the value of a loan in the event of default is completely insulated from climate risks.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (V) only
(B) (I), (II), (III), and (IV) only
(C) (II), (III), (IV), and (V) only
(D) (I), (III), (IV), and (V) only

Oct/Nov 2019

70. Identify the INCORRECT statement regarding the general principles of risk management.
(A) Risk is the product of likelihood and impact, where financial returns deviate from expected values.
(B) Banking risks have seen a phenomenal

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reduction globally due to the impact of innovative products.

(C) Although various risks arise independently, there is a clear interdependency among various risk types.

(D) Operational risk is the risk of loss resulting from inadequate or failed internal systems and external events.

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ANSWERS

1. (D) The impact of non-financial risks can generally be measured quantitatively with precise ease.
Non-financial risks, such as reputation or legal risks, are inherently difficult to quantify compared to financial risks. While financial risks impact the bottom line directly and often use precise quantitative models, non-financial risks affect conditions indirectly. Measuring the impact of public opinion or legal hurdles requires qualitative assessment rather than precise mathematical ease or certainty.

2. (C) Net Demand and Time Liabilities (NDTL)
The Statutory Liquidity Ratio is a regulatory requirement where banks maintain a specific proportion of their assets in liquid forms like gold or government securities. This ratio is calculated based on the bank's Net Demand and Time Liabilities. It serves as a tool for the central bank to control credit growth and ensure bank solvency.

3. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Measuring risk in banking requires understanding the likelihood of an adverse event and the potential magnitude of the resulting loss. This mathematical relationship emphasizes that high probability alone does not define risk without considering the financial consequence. Because risk involves both the chance of occurrence and monetary loss, the impact factor is essential for accurate assessment.

4. (D) (I), (II), and (III)
The Pradhan Mantri Jan Dhan Yojana has significantly transformed financial inclusion by bringing millions into the formal banking system. Success metrics include opening over forty-two crore accounts, with a majority held by women. Additionally, the scheme effectively targets the unbanked population in rural and semi-urban areas, ensuring that the benefits of financial services reach the grassroots level.

5. (B) Positive Externality
When a nation's robust financial system attracts foreign investment, it creates benefits for the broader economy beyond the immediate participants. This scenario illustrates a positive externality, where the sound regulatory environment generates a spillover effect. Such interconnections enhance economic growth and stability by drawing in multinational corporations, benefiting third parties who were not directly involved in the system's creation.

6. (B) December 1, 2016
The Insolvency and Bankruptcy Code was enacted to consolidate and amend laws relating to reorganization and insolvency resolution. While the act was passed earlier in the year, the specific provisions regarding the Corporate Insolvency Resolution Process officially became effective in December. This framework provides a time-bound mechanism for resolving defaults, aimed at maximizing the value of assets.

7. (B) A deviation from the optimum solution, usually expressed in terms of expected loss
Modern risk theory defines risk as the potential for deviation from a desired or expected outcome. It is often quantified in terms of expected loss, representing the uncertainty associated with business processes. Unlike certainty or purely unpredictable failures, risk involves measurable probabilities of negative results. This definition allows organizations to prepare for and manage potential financial impacts systematically.

8. (B) (I), (II), and (IV) only
India's balance-of-payment crisis in the early nineties was triggered by several external and internal factors. The Gulf War caused a sharp rise in oil prices and reduced exports, while foreign exchange reserves dwindled to critically low levels. These conditions forced the government to airlift gold reserves as collateral for international loans to prevent a total economic collapse.

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9. (B) (I), (II), (III), and (V)
In nineteen ninety-three, the Reserve Bank of India introduced specific guidelines to allow new private sector banks. These requirements included maintaining a minimum paid-up capital of one billion rupees and listing shares on stock exchanges. Additionally, these banks had to meet priority sector lending targets and were prohibited from establishing subsidiaries or mutual funds for three years.

10. (C) Credit Risk
Banking risks are broadly categorized into financial and non-financial types. While strategic, compliance, and reputation risks are non-financial because they impact the bank indirectly, credit risk is a primary financial risk. Credit risk involves the direct possibility of loss arising from a borrower's failure to repay a loan, making it a quantifiable and direct financial threat to stability.

11. (D) The demand by governments for global compliance, ensuring "good banks" across borders
Following the global financial crisis, governments and international bodies sought to enhance the stability of the worldwide financial system. The primary driver for expanding regulations is the demand for global compliance and the establishment of sound banking practices across borders. This ensures that banks operating internationally adhere to strict standards, reducing systemic risks and preventing future financial collapses.

12. (C) P-4, Q-3, R-1, S-2
The risk matrix categorizes knowledge and measurement capabilities. Known knowns represent risks that are identified and quantifiable. Known unknowns are identified risks that lack precise measurement. Unknown knowns refer to understood concepts that cannot be measured currently. Finally, unknown unknowns represent scenarios where the organization is neither aware of the risks nor capable of measuring their potential impact.

13. (D) CRR rate as of October 2021 — 9%
Statutory pre-emptions like the Cash Reserve Ratio and Statutory Liquidity Ratio are tools used to regulate banking liquidity. Historically, these rates were much higher, with the peak SLR reaching over thirty-eight percent. However, the Cash Reserve Ratio of nine percent in October twenty-twenty-one is incorrect, as actual rates have been significantly lower to support economic liquidity and growth.

14. (B) (I) and (III) only
The collapse of the Bretton Woods system introduced free-floating exchange rates, which significantly increased currency risks for international trade. Simultaneously, extreme movements in crude oil prices created substantial price risks for both producers and consumers. These developments forced market participants to adopt sophisticated hedging tools to manage the uncertainty and volatility that became prevalent in the global financial landscape.

15. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Larger banks often achieve higher credit ratings because their scale allows for greater geographic and sector diversification. A diversified loan portfolio reduces the impact of localized defaults, leading to more stable and less volatile earnings over time. Because this stability lowers the perceived risk of insolvency, credit rating agencies view larger, well-diversified institutions as more creditworthy than smaller ones.

16. (A) Risk involves known or inferred probabilities, while uncertainty involves unknown probabilities
Frank Knight distinguished risk from uncertainty by focusing on the ability to assign probabilities to outcomes. Risk refers to situations where the likelihood of an event can be calculated or inferred from historical data. In contrast, uncertainty involves scenarios where probabilities are entirely unknown. This distinction is fundamental in finance, as risk can be priced while uncertainty cannot be measured.

17. (A) CAMEL framework adoption — 1999-2000
The Reserve Bank of India significantly enhanced its supervisory mechanisms by adopting the CAMEL framework around

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the turn of the millennium. This framework evaluates Capital adequacy, Asset quality, Management, Earnings, and Liquidity to assess a bank's overall health. This shift marked a move toward a more structured and comprehensive approach to monitoring the financial soundness of the Indian banking sector.

18. (C) Both (I) and (II)
Banking risks are deeply interconnected and can transform from one type to another. For example, a sudden shift in foreign exchange rates can increase a borrower's liability, thereby raising the bank's credit risk exposure. Similarly, market risk mitigation strategies, such as derivative contracts, can eventually result in counterparty credit risk if the hedging partner fails to fulfill their financial obligations.

19. (D) The rate must not exceed the bank's prime lending rate (PLR).
Under the deregulation guidelines issued in late nineties, commercial banks were granted more freedom in pricing small loans. For loans under two hundred thousand rupees, banks could set interest rates independently, provided these rates did not exceed the bank's prime lending rate. This policy aimed to offer competitive rates to retail customers while maintaining a ceiling to protect smaller borrowers.

20. (B) 6% to 8.4%
During the nineteen-eighties, India's economic health deteriorated as the fiscal deficit expanded significantly. The deficit rose from six percent to over eight percent of the Gross National Product. This unsustainable fiscal expansion, combined with external shocks, eventually culminated in the severe balance-of-payment crisis of nineteen ninety-one, necessitating the comprehensive banking and economic reforms that followed.

21. (C) Both (I) and (II)
The Corporate Insolvency Resolution Process under the Indian Bankruptcy Code is designed to be efficient and time-bound. The initial period for completing the process is set at one hundred and eighty days. If the resolution cannot be finalized within this timeframe due to specific circumstances, a one-time extension of ninety days is permitted, totaling a maximum of two hundred seventy days.

22. (B) Control Risk
When a bank fails to meet its credit risk targets due to internal failures like staff complacency or inadequate collateral verification, it illustrates control risk. This risk arises from the breakdown of internal processes and monitoring mechanisms intended to manage exposures. While the outcome involves financial loss, the root cause is the failure of the institution's internal control environment and oversight.

23. (A) (IV), (II), (III), (I)
The financial contagion of the late nineties began in Thailand with the devaluation of the baht. This crisis quickly spread across East Asia, impacting multiple neighboring economies. Subsequently, the instability reached Russia, leading to a debt default. Finally, the ripple effects of the global financial turmoil reached South America, specifically affecting the economic stability and markets of Brazil.

24. (C) April 1998
Following the second Narasimham Committee recommendations, India formally adopted higher capital standards to align with international Basel Accords. In April nineteen ninety-eight, the regulatory minimum capital adequacy ratio was increased to nine percent. This move was intended to strengthen the capital base of Indian banks and improve their resilience against various financial risks in an increasingly globalized environment.

25. (B) To liberalize the sector through deregulation and improving overall financial soundness
The primary objective of the nineteen ninety-one reforms was to move away from a highly regulated and repressed banking system. The committee recommended liberalizing the sector through deregulation, reducing statutory pre-emptions, and enhancing operational flexibility. These changes were aimed at improving the efficiency, productivity, and overall financial soundness of banks, allowing them to compete effectively in a market-driven economy.

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26. (D) Things we are neither aware of nor able to measure, such as Knightian uncertainty
In the context of risk management, unknown unknowns represent events that are completely outside an organization's current knowledge and measurement capabilities. This concept aligns with Knightian uncertainty, where the probabilities of occurrence cannot be determined. These risks are the most difficult to manage because they are neither anticipated nor quantifiable, often resulting from rare or unprecedented events.

27. (A) Balance not exceeding ₹50,000 and aggregate credits not exceeding ₹1 lakh a year.
To promote financial inclusion, relaxed KYC norms allow individuals to open small savings accounts with limited documentation. These accounts are subject to specific operational limits to manage potential risks. The maximum balance permitted at any point in time is fifty thousand rupees, and the total aggregate credits within a single financial year must not exceed one lakh rupees.

28. (A) A negative externality
A negative externality occurs when a transaction or event imposes unintended costs on third parties who are not involved in the original activity. In finance, an unstable banking system that leads to capital flight affects the entire economy, not just the failing institutions. This conceptual framework helps explain why systemic stability is a public good requiring careful regulatory oversight and intervention.

29. (C) (II), (III), (I), (IV)
The deregulation of deposit interest rates in India followed a phased approach. Initially, the central bank fixed the overall maximum rate for term deposits. Subsequently, the minimum maturity for these deposits was lowered to fifteen days. This was followed by the liberalization of rates for term deposits up to two years, and finally, the deregulation of savings bank account rates.

30. (D) It helped in smoothing out the effects of domestic shocks by enabling risk-sharing and diversification.
Globalization has integrated domestic financial systems into the global economy, facilitating easier access to international capital. This interconnectedness allows for better risk-sharing and diversification across different markets and regions. Consequently, the effects of localized domestic shocks can be smoothed out as capital and risk are redistributed, though it also increases the potential for international financial contagion across borders.

31. (C) A borrower or counterparty failing to meet its financial obligations in accordance with agreed terms
Credit risk is the most fundamental risk faced by banks, occurring when a borrower or counterparty is unable or unwilling to fulfill their financial obligations. This failure to pay interest or principal according to agreed terms results in financial loss for the lender. It differs from market or operational risks, as it specifically focuses on the default potential of individual loan exposures.

32. (B) The net interest earnings of the bank will suffer a decline due to Repricing Risk.
A negative gap exists when a bank's interest-sensitive liabilities exceed its interest-sensitive assets. In a rising interest rate environment, the bank must pay higher rates on its liabilities sooner than it can increase rates on its assets. This mismatch leads to higher interest expenses relative to income, causing a decline in net interest earnings, which is a form of repricing risk.

33. (B) (I), (II), and (IV) only
Modern banking leverages big data and machine learning to enhance risk decision-making and detect financial crimes. These technologies identify complex, non-linear patterns in vast datasets that traditional models might miss. Crucially, machine learning models are designed to improve over time as they process more information, rather than degrading, making them highly effective tools for early-warning systems and automated processing.

34. (D) Commodity Price Risk — Risk of financial losses caused by changes in prices for buyers and producers
Commodity price risk refers to the potential for financial loss caused by fluctuations in the market prices of physical goods like oil, metals,

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or agricultural products. This risk impacts both producers, who may receive lower prices, and consumers, who may face higher costs. It is a key component of market risk, distinct from foreign exchange, equity, or specific credit-related settlement risks.

35. (A) Liquidity restriction — Failure to pay due to domestic currency conversion curbs
Country risk involves various forms of sovereign distress, including actual default, restructuring of debt, or politically motivated decisions to stop payments. However, liquidity restrictions are typically internal measures or symptoms rather than the failure to pay due specifically to domestic currency conversion curbs. The latter is more accurately described as transfer risk, where a borrower has funds but cannot convert them for international payment.

36. (A) P-3, Q-1, R-2, S-4
Model risk involves adverse consequences from decisions based on incorrect mathematical outputs. Liquidity risk is the inability to meet cash and collateral obligations as they fall due. Legal risk occurs when contracts become unenforceable because of deficient documentation or regulatory issues. Reputation risk arises from negative public opinion that can hinder a bank's ability to establish or maintain business relationships.

37. (A) "Principles-based compliance" involves asking if practices are "fair" from a customer's perspective.
Modern banking supervision is shifting toward principles-based compliance, which goes beyond strictly following rules to ensure that banking practices are fundamentally fair to customers. This approach requires banks to consider the ethical implications of their products and services. Reliance on existing rules alone is no longer seen as sufficient, as regulators now expect proactive preparedness and automated, accurate compliance systems.

38. (D) The risk of loss arising from adverse movements in the value of trading portfolios
Market risk is the potential for financial loss resulting from changes in market prices, such as interest rates, exchange rates, or equity prices. It specifically targets the value of a bank's trading portfolios and other market-sensitive instruments. While liquidity and legal risks are related, market risk focuses on the volatility of market variables and their impact on the institution's mark-to-market positions.

39. (D) P-2, Q-3, R-1, S-4
Optionality risk arises from various sources in a bank's balance sheet. Liabilities often include the right of early withdrawal on customer deposits. On the asset side, mortgage prepayments by homeowners represent embedded options. Automatic options include standardized exchange-traded interest rate contracts, while behavioral options involve transactions where client conduct changes significantly in response to fluctuating market interest rates.

40. (D) Migration Risk
Migration risk occurs when the credit quality of a borrower or security issuer deteriorates, leading to a downgrade by rating agencies. Although an actual default has not yet happened, the market react by demanding a higher interest rate, which reduces the present value of the future cash flows. This represents a decline in the value of the bank's investment due to credit quality shifts.

41. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Banks face a trade-off between maintaining liquidity and maximizing profitability. Liquid assets, such as cash or short-term government securities, provide safety but typically offer much lower returns than long-term loans. Therefore, holding an excessive amount of liquid assets ensures the bank can meet immediate obligations but negatively impacts long-term earnings because capital is not deployed in higher-yielding, less liquid loan assets.

42. (C) The automated instant decisioning for loan disbursements
Model errors typically arise from issues with data quality, technical implementation flaws, or unforeseen inconsistencies in the data. While automated instant decisioning for loans utilizes models, the automation process itself is a strategic or operational choice rather than a source of mathematical or theoretical error.

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Model error specifically refers to the failures within the logic, data, or calculation of the model itself.

43. (B) GAP Risk
Gap risk occurs when there is a mismatch in the timing of interest rate changes between a bank's assets and its liabilities. If the interest rates on a bank's liabilities increase before the rates on its assets do, the bank's net interest margin will be squeezed. This risk is inherent in the maturity or repricing schedules of the bank's balance sheet items.

44. (D) Counterparty Credit Risk
Counterparty credit risk is the bilateral risk that a partner in a financial transaction, such as an over-the-counter derivative, will default before the final settlement. Unlike traditional unilateral credit risk, the value of these contracts fluctuates, meaning either party could be owed money depending on market movements. This risk is particularly significant in complex, long-term swap or forward agreements.

45. (C) Model errors and the absence of adequate tools for measuring risks.
Under the operational risk framework, process risk includes organizational deficiencies, inadequate procedures for booking transactions, and technical system failures. However, model errors and the absence of adequate tools for measuring risks are generally classified under a separate category known as model risk or technical risk, rather than falling strictly within the day-to-day operational process risk definition.

46. (B) Automated instant decisions
Banks are increasingly adopting technology to provide rapid, real-time responses to loan applications. By pre-populating data from public sources and using automated algorithms, institutions can drastically reduce the time needed for credit assessment. This strategic priority focuses on improving the customer experience through speed and efficiency, representing a significant shift from traditional, manually intensive underwriting processes.

47. (C) Systematic risk pertains to a certain firm and can be successfully mitigated through diversification.
Equity price risk consists of systematic and unsystematic components. Unsystematic risk is specific to a particular firm and can be reduced through a well-diversified portfolio. However, systematic risk refers to broader market or macroeconomic forces that affect all securities simultaneously. Consequently, systematic risk cannot be mitigated through simple diversification, as it is inherent to the entire market environment.

48. (B) P-4, Q-1, R-3, S-2
Default risk is the possibility that a borrower fails to repay debt on time. Migration risk refers to the deterioration of credit quality, often signaled by a ratings downgrade. Recovery risk is the uncertainty regarding the amount a bank can reclaim after a default. Settlement risk occurs when one party delivers on a transaction but the other fails to provide payment simultaneously.

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49. (A) Basis Risk
Basis risk arises when the interest rates of assets and liabilities are tied to different benchmarks that do not move in perfect correlation. In this scenario, the rise in the CD rate without a corresponding increase in the T-Bill rate narrowed the bank's net interest income. This mismatch between the indices used for pricing causes volatility in earnings even if maturities are matched.

50. (C) (I) and (III) only
The Sovereign Default Database reveals significant historical trends in government debt failures. Since nineteen sixty, a large majority of sovereigns have experienced defaults on their financial obligations. Recent data highlights specific instances, such as Lebanon's first-time default on foreign currency bonds. However, reports of a forty-eight percent decrease in total sovereign debt in default for twenty-twenty are inconsistent with global economic trends.

51. (D) Model Risk
Model risk materializes when a bank suffers losses due to errors in the design, implementation, or usage of quantitative models. In this case, a

fundamental coding error led the algorithm to produce incorrect credit scores, resulting in the approval of bad loans. Because the financial loss stems directly from a flaw in the mathematical model's logic, it is classified as model risk.

52. (D) Operational Risk
Cyber attacks, including network breaches and the theft of confidential customer data, are managed under the broad category of operational risk. This type of risk encompasses losses resulting from inadequate or failed internal systems, external events, and human factors. As technology is central to modern banking, protecting against digital disruptions is a critical component of maintaining operational resilience and security.

53. (C) Delivery versus Payment (DvP), CCP clearinghouses, and PvP mechanisms
Settlement risk is mitigated through specialized payment and clearing mechanisms that ensure transactions are completed safely. Delivery versus Payment ensures that securities are transferred only when payment is received, while Payment versus Payment handles foreign exchange settlements. Central Counterparties also act as intermediaries, guaranteeing the performance of trades and reducing the risk of one party failing to deliver their part of the deal.

54. (C) Yield Curve Risk
Yield curve risk occurs when shifts in the relationship between interest rates of different maturities impact a bank's earnings. When a bank funds long-term assets with short-term liabilities, it is sensitive to changes in the slope of the yield curve. If the curve flattens, the spread between long-term and short-term rates narrows, which can severely reduce the bank's net interest margin.

55. (A) In the trading book, it refers to the risk of loss in the values of fixed income securities caused by adverse changes in interest rates.
In the trading book, interest rate risk primarily refers to the potential decline in the market value of fixed income securities and other trading instruments due to rate fluctuations. This is a mark-to-market risk. In contrast, interest rate risk in the banking book focuses on how rate changes impact the bank's overall net interest income and the economic value of its equity over time.

56. (A) Central banks are the only entities that need to worry about and track contagion risk.
While central banks monitor systemic stability, individual banks must also actively manage contagion risk to protect their own financial health. The interconnectedness of global markets means that negative developments can spread rapidly through capital flows. Banks must assess their exposures to other institutions and markets, as contagion risk is a factor for both global systemically important banks and smaller domestic institutions.

57. (D) (I), (II), (III), (IV), and (V)
Operational risk is a broad category triggered by failures across various internal and external dimensions. These include human errors or fraud, inadequate or failed internal processes, and technical flaws in model implementation. Furthermore, technology failures such as system outages and external events like natural disasters or cyber-attacks contribute to this risk. Managing these diverse triggers is essential for maintaining the bank's operational integrity.

58. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Recovery risk directly affects the final loss a bank sustains after a borrower defaults. It stems from the uncertainty associated with the value of collateral and the costs of legal enforcement. Because the amount eventually recovered can vary significantly due to market conditions or legal delays, an exposure with high recovery risk is fundamentally more dangerous, as it often results in a higher net loss.

59. (A) (I), (II), and (IV) only
Optionality risk involves price movements in instruments where the timing or amount of cash flows can change. This includes automatic options like exchange-traded contracts and behavioral options like mortgage prepayments. In these scenarios, the option seller usually faces high downside risk and limited upside, as the buyer only exercises the option when

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it is financially advantageous for them and disadvantageous for the bank.

60. (C) Both (I) and (II)
Traditional credit risk is usually unilateral, where the bank faces loss if the borrower defaults. In contrast, counterparty credit risk is bilateral, occurring in transactions like derivatives where the contract's value can shift between positive and negative for either side. This means that at different times, either the bank or its counterparty could be the one facing credit exposure if the other fails.

61. (C) Business Risk
Business risk arises when a bank's chosen strategy fails due to changes in the external environment, such as technological advancements or shifts in consumer preferences. In this case, the bank's investment in door-to-door marketing became obsolete because of the rise of internet banking. This failure to achieve business goals due to poor alignment with market trends is a classic example of business risk.

62. (A) Compliance Risk
Compliance risk involves the potential for legal or regulatory sanctions and financial loss resulting from a failure to follow laws, regulations, or ethical standards. This risk often leads to civil money penalties and the voiding of contracts. Because it is deeply embedded in daily transaction processing and operational activities, it is frequently overlooked until a violation occurs, resulting in significant reputational and financial damage.

63. (C) Legal Risk
Legal risk occurs when a bank's contracts are unenforceable or when legal proceedings result in financial loss. In this scenario, the bank's inability to seize collateral due to jurisdictional issues and poor documentation directly illustrates this risk. It highlights the importance of maintaining robust legal frameworks and accurate documentation, especially in cross-border transactions where multiple legal systems and complex regulations are involved.

64. (C) Business risk concerns product markets and innovation, while strategic risk involves organizational goals and implementation.
Business risk focuses on the uncertainties of the market, including competition, product innovation, and customer demand. Strategic risk, however, relates to the high-level decisions made by management regarding the bank's long-term goals and the effectiveness of their implementation. While both are non-financial, business risk is more about market dynamics, while strategic risk centers on the failure of organizational plans and management choices.

65. (B) P-3, Q-4, R-1, S-2
Within payment systems, liquidity risk is a participant's inability to meet obligations when due. Legal risk arises from poor frameworks that create uncertainty. Operational risk involves technical malfunctions that exacerbate other risks. Systemic risk is the most severe, where the failure of one participant to meet obligations causes a chain reaction of liquidity or credit problems that threatens the entire financial system's stability.

66. (D) The risk of being unable to absorb losses with the bank's available capital
Solvency risk is the ultimate risk that a bank will not have sufficient capital to absorb its financial losses, leading to bankruptcy. While other risks like credit or market risks cause the losses, solvency risk specifically concerns the bank's overall capacity to survive those hits. Maintaining adequate capital buffers is the primary defense against this risk, ensuring the institution remains viable even during stress.

67. (D) Strategic Risk
Strategic risk materializes when a bank's management fails to effectively implement organizational goals or makes poor decisions about resource allocation. In this scenario, the lack of communication and training during an aggressive expansion led to a failure that damaged the bank's franchise value. This highlights how the mismatch between ambitious plans and the bank's actual capacity can lead to significant long-term strategic damage.

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68. (B) Repricing risk
A breakdown in payment and settlement systems can trigger several severe risks, including credit risk from failed deliveries and liquidity risk from delayed payments. It can also lead to systemic risk if the failure spreads across the financial network. However, repricing risk is specifically related to interest rate fluctuations and maturity mismatches on the balance sheet, rather than the operational mechanics of payment systems.

69. (B) (I), (II), (III), and (IV) only
Banks face climate risks through physical drivers like extreme weather and transition drivers like policy changes to reduce emissions. These factors can reduce a borrower's ability to service debt, thereby increasing credit risk. Contrary to the idea of insulation, banks' recovery values are also vulnerable, as the market value of collateral may decline due to climate-related damage or the shifting economic landscape.

70. (B) Banking risks have seen a phenomenal reduction globally due to the impact of innovative products.
Despite the development of innovative products and sophisticated risk management tools, banking risks have not seen a phenomenal reduction globally. In fact, financial innovation and globalization have often introduced new, complex interdependencies and risks. While management techniques have improved, the inherent volatility of markets and the potential for systemic crises remain significant challenges that require constant vigilance and robust regulatory frameworks.

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CHAPTER 03
Risk Management Framework

Oct/Nov 2014

1. In the context of risk measurement tools, which of the following indicates the level of risk?
(A) Statistical models
(B) Flow charts
(C) Stress testing models
(D) Rating models

May/June 2021

2. Identify the incorrect statement regarding risk sharing.
(A) Risk sharing is defined as sharing with another party the burden of loss or the benefit of gain from a risk.
(B) Outsourcing and insurance are considered risk sharing tools, rather than risk prevention tools.
(C) Risk sharing means that the risk is completely avoided by transferring it to a third party.
(D) In the case of insurance, the compensation, if any, is received post event to help reduce the loss caused by risk.

Oct/Nov 2007

3. Which of the following defines risk appetite?
(A) The maximum exposure a firm takes given its capital and laws.
(B) The projected monetary losses expected if a set of risks occur.
(C) The risk levels an entity assumes to meet strategic objectives.
(D) The reduction of risk by decreasing the likelihood of incidents.

May/June 2013

4. What is the primary rationale for adopting the balanced scorecard approach in fixing performance indicators for risk management?
(A) Maximizing short-term sales and immediate business profitability.
(B) Basing compensation on public stock market valuation performance.
(C) Augmenting financial metrics with quality and process measures.
(D) Eliminating the requirement for manual front-line control reviews.

Oct/Nov 2024

5. In the context of Enterprise Risk Management, how are events with a positive impact treated?
(A) They are categorized strictly as residual risks.
(B) They are opportunities that support value creation.
(C) They are considered compliance breaches in limits.
(D) They are transferred to external agencies via sales.

May/June 2008

6. What is the underlying premise of enterprise risk management (ERM)?
(A) Organizations must reinvent business models to remove hazards.
(B) Managing uncertainty to increase stakeholder value within the entity.
(C) Reaching goals by ignoring certain compliance or reporting rules.
(D) Performing risk identification as a single, static capture exercise.

Oct/Nov 2011

7. What is the definition of risk management in the world of finance?
(A) Developing internal systems for the total removal of all banking hazards.
(B) Proactively identifying, analyzing, and taking steps to reduce risks.
(C) Outsourcing all financial liability to external third-party agencies.
(D) Increasing expected returns by disregarding safety limits across sectors.

May/June 2025

8. Identify the correct statement regarding the limitations of enterprise risk management.
(A) Enterprise risk management guarantees absolute assurance as to the achievement

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of the entity's objectives.
(B) Controls within enterprise risk management can be circumvented by collusion of two or more people.
(C) Breakdowns in enterprise risk management cannot occur due to simple human errors or mistakes.
(D) Management does not have the ability to override enterprise risk management decisions.

Oct/Nov 2005

9. An organization's risk appetite statement may provide direction on several aspects. Which of the following is NOT a key factor to be kept in mind when developing a possible model for risk appetite?
(A) Risk appetite needs to be a measurable concept with some form of meaningful "yardstick".
(B) Risk appetite is a static concept written in tablets of stone that remains unchanged for the rest of the year.
(C) There is no single risk appetite, but rather a range of appetites for different types of risk.
(D) Risk appetite has at least two components: risk and control.

May/June 2016

10. How does a bank's failure to differentiate risks and under-pricing risk to risky customers affect its portfolio in the long run?
(A) It encourages good borrowers to increase their credit limits.
(B) It creates an optimal balance between expected return and risks.
(C) It discourages good clients while attracting relatively bad ones.
(D) It reduces the sensitivity of the bank's earnings to variables.

Oct/Nov 2018

11. The following are steps involved in the risk identification process:
1. Understanding and having knowledge of the business.
2. Documenting the identified risks in a risk register.
3. Identifying unwanted events, undesirable outcomes, and emerging threats.
4. Reviewing past experiences and the experiences of others.

What is the correct logical sequence of these steps?
(A) 1, 4, 3, 2
(B) 4, 1, 2, 3
(C) 1, 3, 4, 2
(D) 3, 1, 2, 4

May/June 2007

12. In a standard organizational structure for risk management, who has the ultimate responsibility for the management and performance of a company and is responsible for its governance?
(A) Executive Management
(B) Risk Management Committees
(C) Board of Directors
(D) Internal Audit Functionaries

Oct/Nov 2009

13. Identify the incorrect statement regarding the Board of Directors' role in the organizational structure of risk management.
(A) The board members must take part in day-to-day operations and activities to effectively manage risks.
(B) The board of directors decides on the blend of optimal return and minimum risk given the bank's risk profile.
(C) The board evaluates the methods used for risk assessment as also the organizational structure proposed for the function.
(D) The board meets regularly with senior management and internal auditors to review and approve policies.

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May/June 2023

14. Identify the correct statement regarding a bank's risk management policy.
(A) The risk management policy typically contains specific issues pertaining exclusively to the management of loans and investments.
(B) The changes in market conditions do not alter the assumptions that were made at the time of the risk management policies formulation.
(C) The risk management policy is a general document on the bank's risk management philosophy and risk appetite.
(D) The risk management policy is formulated solely by the internal audit functionaries.

Oct/Nov 2025

15. Why is it essential for line functionaries to gather sufficient details of the market situation?
(A) To bypass sound risk management practices for short-term gains.
(B) To evaluate the organizational structure proposed for the risk function.
(C) To set the overall strategic direction of the bank.
(D) To make informed decisions on pricing.

May/June 2012

16. How is risk culture defined?
(A) Shared norms influencing group risk behavior and decisions.
(B) Statutory frameworks that penalize unauthorized risk-taking.
(C) Systems for identifying risks and establishing deal methods.
(D) Maximum risk levels an institution assumes given its capital.

Oct/Nov 2019

17. At a minimum, a risk register records all of the following information, EXCEPT:
(A) The specific names of employees responsible for the risk occurrence
(B) Risk category
(C) How will the risk impact the institution if it materializes
(D) The existing internal controls that may minimize the likelihood of the risk occurring

May/June 2019

18. In the relationship of objectives and components in Enterprise Risk Management, the four objectives' categories are represented by vertical columns. What are these four categories?
(A) Strategic, Operations, Reporting, and Compliance
(B) Planning, Execution, Monitoring, and Feedback
(C) Internal Environment, Risk Assessment, Control Activities, and Monitoring
(D) Identification, Measurement, Mitigation, and Control

Oct/Nov 2006

19. Identify the incorrect statement about the risk register.
(A) The risk register is the main output of a risk identification exercise.
(B) The risk register records how and why the risk is likely to happen, also known as the "cause of risk".
(C) The risk register records the existing internal controls that may minimize the likelihood of the risk occurring.
(D) The risk register only documents risks that have materialized and resulted in quantitative losses.

May/June 2005

20. Identify the correct statement concerning risk reduction as a risk mitigation strategy.
(A) Taking collateral to lower potential losses from a default.
(B) Transferring risks to an external agency via securitization.
(C) Avoiding any activity that could carry a potential threat.
(D) Managing the risk internally when the exposure is minimal.

Oct/Nov 2022

21. The following are steps involved in the risk identification process:
1. Event Identification
2. Risk Response
3. Objective Setting
4. Risk Assessment

What is the correct chronological sequence of these components?
(A) 3, 1, 4, 2
(B) 1, 4, 2, 3
(C) 3, 4, 1, 2
(D) 4, 3, 2, 1

May/June 2018

22. In terms of risk limits, if a bank's board of directors fixes the aggregate risk limit at a certain percentage of owned funds, what is the remaining unallocated balance typically earmarked for?
(A) Market risks
(B) Residual risks
(C) Credit risks
(D) Operational risks

Oct/Nov 2016

23. What is the primary role of the Management Information System (MIS) in balance sheet

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management within the risk management framework?
(A) To execute transactions independently without manual intervention.
(B) To act as the third line of defence in the organizational structure.
(C) To set the overall strategic direction of the bank and its limits.
(D) To provide decision-support and data maintenance for management.

May/June 2014

24. The risk management architecture refers to the design of the risk management framework to manage risks faced by a bank. It should take care of all the following requirements, EXCEPT:
(A) It should capture the whole range of risks faced by a bank.
(B) It should provide an integrated approach to risk management.
(C) It should include procedures for assessment of capital requirement and allocation of capital.
(D) It should replace the internal audit function with automated reporting systems.

Oct/Nov 2010

25. Identify the incorrect statement regarding the lessons learned from financial crises.
(A) Firms must ensure incentives do not trigger bad behaviors.
(B) Concentrating decision-making power in single individuals.
(C) Employees must know how business adds to the risk profile.
(D) Measures must be part of management reporting processes.

May/June 2009

26. What does risk mitigation mean?
(A) Avoiding any business ventures that might produce financial losses.
(B) Calculating the exact dollar amount of any potential future harm.
(C) The ongoing administrative review of all various loss exposures.
(D) Reducing risk exposure and the likelihood of an adverse incident.

Oct/Nov 2024

27. Which of the following functions should be institutionalized to supervise overall risk management at the bank and must ideally be independent from those who assume or accept risks?
(A) The Risk Management Function
(B) The Board of Directors
(C) The line management
(D) The external audit agency

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May/June 2010

28. Why is an Enterprise Risk Management (ERM) framework superior to a silo-based risk management strategy?
(A) It addresses interdependencies through integrated reporting.
(B) A silo strategy captures risk interdependencies too rigidly.
(C) A silo strategy focuses solely on qualitative expense costs.
(D) ERM eliminates all gaps associated with the internal audit.

Oct/Nov 2015

29. All of the following are benefits of effective risk management, EXCEPT:
(A) Better achievement of business objective
(B) Reduced volatility in earning and market value
(C) Eliminating the need for maintaining liquid cash flows
(D) Balancing risk and reward

May/June 2017

30. Identify the correct statement regarding the components of risk culture motivation.
(A) Performance management should ensure that all employees understand and live the bank's risk appetite statement.
(B) Accountability dictates that the recruiting process should take into consideration a prospective employee's predisposition toward risk.
(C) Risk orientation ensures that Key Performance Indicators (KPIs) of senior management exclude risk management measures.
(D) Employee risk taking should be premised on the bank's risk appetite and be in line with the approach to risks managed by the bank.

Oct/Nov 2021

31. Which of the following correctly pairs the internal audit functionary duty with its objective?

(A) Advising on design and improvement of control systems - Acting as the first line of defence in risk management.

(B) Executing the internal audit process - Setting the overall strategic direction of the bank.

(C) Reviewing assessments to provide feedback for internal control.

(D) Overseeing the implementation of risk strategy - Determining the business mix and selecting risk grades of loans.

May/June 2024

32. Consider the following statements regarding the components of Risk Culture:

I Recruitment and induction processes should ignore a prospective employee's past experience of risk management.

II Values and Ethics dictate that personnel do not expose the bank to imprudent risk taking by working outside ethical principles.

III Effective communication requires structured channels to ensure risk reporting within the bank.

IV The Board of Directors and senior management should be the main drivers of embracing the appropriate risk culture.

V Banks should encourage constructive challenge on risk-related discussions without fear of reprisal.

Which of the above statements is/are correct?

(A) (I), (II), (IV), and (V) only

(B) (II), (III), (IV), and (V) only

(C) (I), (III), (IV), and (V) only

(D) (I), (II), (III), and (IV) only

Oct/Nov 2008

33. Match the levels of Organizational Structure in List I with their core responsibilities in List II.

List I: Organizational Structure Levels

P. Board of Directors

Q. Executive Management

R. Line Functionaries

S. Internal Audit Functionaries

List II: Core Responsibilities

1. Implementing risk management policy on a day-to-day basis and operating within relevant levels of authority.
2. Setting overall strategic direction, including fixing risk tolerance limits.
3. Effectiveness review of risk assessments and the internal controls with a dispassionate outlook.
4. Evaluating overall risks faced by the bank and determining the level of risks in the best interest of the bank.

(A) P-2, Q-3, R-1, S-4

(B) P-1, Q-4, R-2, S-3

(C) P-2, Q-4, R-1, S-3

(D) P-4, Q-2, R-3, S-1

May/June 2006

34. Read the statements of Assertion (A) and Reason (R) and select the correct option.

Assertion (A): Enterprise risk management provides reasonable assurance to management and the board regarding the achievement of objectives relating to the reliability of reporting and compliance.

Reason (R): Objectives relating to the reliability of reporting and compliance with laws and regulations are entirely within the entity's control.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2017

35. Read the following statements and select the correct option:

Statement I: Securitization and insurance are examples of risk transfers, where insurance is a post risk loss management strategy.

Statement II: Complete elimination of risk is frequently possible in the banking business by applying appropriate risk mitigation strategies.

(A) Both Statement I and Statement II are correct.

(B) Both Statement I and Statement II are incorrect.

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(C) Statement I is correct, but Statement II is incorrect.
(D) Statement I is incorrect, but Statement II is correct.

May/June 2011

36. Read the following scenario and answer the question that follows.
Beta Bank's Board noticed that the head of the trading desk generated massive short-term profits but exposed the bank to excessive unhedged market positions. The executive's annual bonus was based solely on revenue generation.
To correct this behavior and align it with the risk culture framework, what specific component of Motivation should Beta Bank implement?
(A) Use risk-weighted performance measures in bonuses.
(B) Remove all boundaries on the desk's trading activities.
(C) Promote the idea of open challenge without retaliation.
(D) Transfer trading desk risks to a third-party insurer.

Oct/Nov 2013

37. Match the components of the Risk Culture Framework in List I with their corresponding elements in List II.
List I: Risk Culture Components
P. Risk Competence
Q. Organization
R. Relationships
S. Motivation
List II: Elements
1. Effective Communication, Leadership, Challenge
2. Recruitment and Induction, Learning, Skills
3. Performance Management, Risk Orientation, Accountability
4. Strategy and Objectives, Values and Ethics, Policies, Processes and Procedures
(A) P-2, Q-4, R-1, S-3
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2015

38. Consider the following statements regarding Risk Limits:
I Risk limits determine the volume of business that can be undertaken in different areas and the quality of assets that can be accepted.
II The overall risk limit can be fixed as a percentage of the total capital.
III Risk limits are allocated between different types of risks purely on hypothetical bases.
IV Business opportunities, market competition, and historical loss experiences influence the allocation of limits.
Which of the above statements is/are correct?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), and (IV) only

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Oct/Nov 2012

39. Read the statements of Assertion (A) and Reason (R) and select the correct option.
Assertion (A): It is widely accepted that risk limits are an integral part of a sound risk management program.
Reason (R): Just as business strategies and product plans tell a business where to go, risk limits and boundaries tell a business when to stop.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2020

40. Which of the following incorrectly pairs the Enterprise Risk Management component with its function?
(A) Objective Setting - Ensuring management has a process to set objectives that support and align with the entity's mission.
(B) Event Identification - Distinguishing between risks and opportunities regarding internal and external events.
(C) Monitoring - Accomplishing the entirety

of ERM oversight through ongoing management activities or separate evaluations.

(D) Risk Response - Analyzing risks purely on an inherent basis without selecting any responses.

May/June 2022

41. Read the following scenario and answer the question that follows.

Gamma Bank is conducting a risk identification exercise for its new digital banking platform. The risk managers identify a potential cyber-attack that could disrupt services for 48 hours. They estimate the financial impact and note the existing firewalls.

If this information is documented in the "risk register," which mandatory element is missing from the minimum records required?

(A) The name of the auditor
(B) The risk category and cause of risk
(C) The strategic objectives of the bank
(D) The historical loss experiences of competitors

Oct/Nov 2023

42. Match the Enterprise Risk Management components in List I with their primary functions in List II.

List I: Enterprise Risk Management Components

P. Internal Environment
Q. Risk Assessment
R. Control Activities
S. Information and Communication

List II: Primary Functions

1. Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.
2. Relevant information is identified, captured, and communicated in a form and timeframe that enables people to carry out responsibilities.
3. Encompasses the tone of an organization and sets the basis for how risk is viewed and addressed.
4. Risks are analyzed, considering likelihood and impact, as a basis for determining how they should be managed.

(A) P-3, Q-4, R-1, S-2
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2020

43. Consider the following statements regarding the Risk Management Policy:

I It should act as a reference manual for risk management for all personnel in the bank.
II It outlines the link between risk management strategies and the bank's business plan.
III It should contain specific issues pertaining to the management of loans and investments.
IV Identification and measurement procedures and methods should be clearly spelt out in the policy.

Which of the above statements is/are correct?

(A) (I), (II), and (III) only
(B) (I), (II), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

Oct/Nov 2018

44. Consider the following statements regarding Enterprise Risk Management (ERM):

I ERM is applied across the enterprise, at every level and unit, and includes taking an entity-level portfolio view of risk.
II ERM is designed to identify potential events that will affect the entity and manage risk within its risk appetite.
III ERM provides absolute assurance to an entity's management and board of directors regarding the achievement of objectives.

Which of the above statements is/are correct?

(A) (II) and (III) only
(B) (I) and (III) only
(C) (I), (II), and (III)
(D) (I) and (II) only

May/June 2016

45. Read the following scenario and answer the question that follows.

Alpha Bank operates its credit, market, and operational risk departments completely independently. The credit department assessed a corporate client favorably, unaware that the market risk department had flagged the client's industry for severe upcoming volatility. The bank suffered huge aggregate exposures.

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This failure highlights the weakness of which type of risk management strategy?
(A) Enterprise Risk Management (ERM)
(B) Holistic Risk Management
(C) Silo-based risk management
(D) Risk Optimization

Oct/Nov 2009

46. Match the Risk Mitigation categories in List I with their corresponding actions in List II.
List I: Risk Mitigation Categories
P. Avoid
Q. Reduce
R. Share
S. Retain
List II: Actions
1. Optimize - mitigate
2. Eliminate, withdraw from or not become involved
3. Accept and contain
4. Diversify-transfer - outsource or insure
(A) P-2, Q-3, R-1, S-4
(B) P-2, Q-1, R-4, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2023

47. Read the statements of Assertion (A) and Reason (R) and select the correct option.
Assertion (A): A silo-based risk management approach effectively tracks and aggregates counterparty risk exposures across the organization.
Reason (R): If business units use different methodologies and systems to track counterparty risk, then it would be difficult to quantify the aggregate exposure for a single counterparty.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2025

48. Which of the following incorrectly pairs the benefit of risk management with its description?
(A) Balancing Risk and Reward - Screening borrowers and differentiating the prices according to their standing.
(B) Reduced Volatility in Earning - Focusing on short-term profitability while deliberately ignoring potential bubbles.
(C) Competitive Advantage - Taking risks more consciously and gaining the expertise to price risks.
(D) Strengthening Liquidity - Ensuring that the firm's cash flows are healthy so that immediate obligations are taken care of.

May/June 2007

49. Consider the following statements regarding Risk Management Committees:
I They consist of executive directors and business line heads of functional departments.
II They advise and support the executive committee regarding the monitoring of overall risk appetite.
III They operate completely independent of the business strategy, objectives, and corporate culture.
IV They review possible scenarios, including stressed scenarios, to assess how the institution's risk profile reacts.
V They assess the recommendations of internal or external auditors and follow up on implementation.
Which of the above statements is/are correct?
(A) (I), (II), (IV), and (V) only
(B) (I), (II), (III), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (III), (IV), and (V) only

Oct/Nov 2014

50. Consider the following statements about the Executive Management's role in risk management:
I It reports directly to the Board of Directors.
II It evaluates overall risks faced by the bank and determines the level of risks which will be in the best interest of the bank.
III It takes part in the day-to-day operations and acts as the supreme decision-making

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body of the bank.

Which of the above statements is/are correct?

(A) (II) and (III) only
(B) (I) and (III) only
(C) (I) and (II) only
(D) (I), (II), and (III)

May/June 2019

51. Read the following scenario and answer the question that follows.

At Beta Bank, a branch manager aggressively sanctioned loans beyond the bank's defined risk appetite to meet quarterly targets, resulting in massive defaults. When questioned, the manager claimed lack of awareness regarding the risk appetite statement.

Under the 'Risk Culture' framework, holding the manager liable for taking imprudent risks falls under which sub-component of Motivation?

(A) Performance Management
(B) Learning
(C) Risk Orientation
(D) Accountability

Oct/Nov 2006

52. Which of the following correctly pairs the risk management architecture element with its corresponding requirement?

(A) Capital allocation methods - Assessing funding requirements and making arrangements to meet them.
(B) Risk identification process - Measuring separately borrower-specific or facility-specific potential losses.
(C) Risk monitoring - Assigning a qualitative value to a newly identified risk.
(D) MIS - Processing control data to produce necessary information reports.

May/June 2021

53. Read the following statements and select the correct option:

Statement I: The risk measurement tools should quantify the potential loss that the bank may suffer, which consists solely of unexpected losses.

Statement II: Rating models indicate the level of risk, whereas statistical models measure the potential loss.

(A) Both Statement I and Statement II are correct.
(B) Both Statement I and Statement II are incorrect.
(C) Statement I is correct, but Statement II is incorrect.
(D) Statement I is incorrect, but Statement II is correct.

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Oct/Nov 2010

54. Read the statements of Assertion (A) and Reason (R) and select the correct option.

Assertion (A): Under-pricing risk to risky customers and over-pricing good risks results in adverse selection for banks.

Reason (R): Banks that do not differentiate risks treat risky and safe borrowers more or less equally, causing discouraging of good clients and attracting of bad ones.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2025

55. Consider the following statements regarding the steps taken by the Board of Directors with inputs from senior management:

I Set the overall strategic direction of the bank, including fixing risk tolerance limits.
II Monitor the financial reporting process to strictly act as internal audit functionaries.
III Review performance and responsibilities of the bank's senior management and consider accountability.
IV Evaluate the methods used for risk assessment as also the organizational structure proposed for the function.

Which of the above statements is/are correct?

(A) (I), (III), and (IV) only
(B) (I), (II), and (III) only
(C) (II), (III), and (IV) only
(D) (I), (II), and (IV) only

Oct/Nov 2019

56. Match the categories of entity objectives in Enterprise Risk Management in List I with their descriptions in List II.

List I: Categories of Entity Objectives
P. Strategic
Q. Operations
R. Reporting
S. Compliance
List II: Descriptions
1. Effective and efficient use of its resources
2. High-level goals, aligned with and supporting its mission
3. Compliance with applicable laws and regulations
4. Reliability of reporting
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-2, Q-1, R-4, S-3

May/June 2009

57. Read the following scenario and answer the question that follows.
Alpha Bank's retail division utilizes a standardized process for loan documentation. Recently, several loans defaulted, and during the recovery process, it was discovered that the initial loan documentation was flawed, leading to severe financial losses that the collateral could not cover.
According to the risk management approach, this scenario best exemplifies the interdependency between which two types of risks?
(A) Operational risk and financial (credit) risk
(B) Market risk and liquidity risk
(C) Business risk and market risk
(D) Strategic risk and compliance risk

Oct/Nov 2011

58. Read the following statements and select the correct option:
Statement I: Risk monitoring precedes risk control, and they complement each other.
Statement II: The monitoring group within the organization should consist of personnel who are directly responsible for operational duties to ensure real-time oversight.
(A) Both Statement I and Statement II are correct.
(B) Both Statement I and Statement II are incorrect.
(C) Statement I is correct, but Statement II is incorrect.
(D) Statement I is incorrect, but Statement II is correct.

May/June 2010

59. Consider the following statements regarding how risk management ensures better achievement of business objectives:
I Target investment returns and product pricing reflect the underlying risks.
II Capital is allocated to projects with the lowest possible risk-adjusted returns.
III Risk transfer strategies are executed to optimize portfolio risk and return.
IV Performance metrics and incentives are in congruence with the bank's business and risk objectives.
V Key management decisions, such as mergers and acquisitions, explicitly incorporate the element of risk.
Which of the above statements is/are correct?
(A) (I), (II), (IV), and (V) only
(B) (II), (III), (IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (III), and (IV) only

Oct/Nov 2024

60. Consider the following statements about Risk Measurement:
I The tools that include rating models should identify borrowers whose financial strength has deteriorated and are likely to default.
II The risk measurement models should be standard across all banks regardless of their size or business mix.
III Regulatory standards require banks to set up separate risk measurement models for estimation of potential losses from credit, market, and operational risks.
Which of the above statements is/are correct?
(A) (I), (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

May/June 2017

61. Read the following scenario and answer the question that follows.
Zeta Bank recently appointed a new member to its Board of Directors. This member holds significant shares in a rival financial institution and actively participates in the day-to-day

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operations of Zeta Bank's credit department.
Based on the organizational structure requirements for the Board of Directors, which principle is being violated?
(A) Board members should avoid setting any strategic goals.
(B) Board members must exclusively manage internal audits.
(C) Avoiding day-to-day operations to prevent conflicts.
(D) Board members are not allowed to review risk reports.

Oct/Nov 2005

62. Read the following scenario and answer the question that follows.
Delta Bank processes hundreds of SME loan applications monthly. Instead of stopping SME lending entirely due to default fears, the bank implemented rigorous pre-sanction due diligence and demanded high-quality collateral to lower the severity of impact.
This approach is best classified as which risk mitigation technique?
(A) Risk Reduction
(B) Risk Avoidance
(C) Risk Retention
(D) Risk Sharing

May/June 2020

63. Read the following scenario and answer the question that follows.
Gamma Bank is evaluating the launch of a complex derivative product where the potential consequences of failure are catastrophic. The bank has a sufficient budget for the risk identification and analysis exercise.
Which of the following approaches is most cost-effective and appropriate for Gamma Bank to use in this specific situation?
(A) Using a basic checklist.
(B) General scenario analysis.
(C) Utilizing flow charts and operational models.
(D) Relying on personal senior judgments.

Oct/Nov 2015

64. Read the following scenario and answer the question that follows.
During Eta Bank's ERM rollout, the risk team analyzes a newly identified cybersecurity threat. They evaluate the likelihood of the threat materializing and the potential financial impact it would have on the bank both before any controls are applied and after existing controls are factored in.
This specific activity corresponds to which component of the ERM framework?
(A) Event Identification
(B) Internal Environment
(C) Risk Assessment
(D) Monitoring

May/June 2013

65. Read the following scenario and answer the question that follows.
The Chief Risk Officer of Epsilon Bank is tasked with allocating the newly calculated aggregate risk limits across different types of risks. The CRO decides to divide the limits equally among credit, market, and operational risks on a hypothetical basis.
Based on the risk limits framework, why is the CRO's approach incorrect?
(A) Risk limits should only be allocated to credit risk.
(B) Limits must link to historical data and business mix.
(C) Residual risks must account for half of the total limit.
(D) Market risk limits must always be higher than credit.

Oct/Nov 2021

66. Read the following scenario and answer the question that follows.
Delta Bank holds a large portfolio of sub-prime mortgage loans. To manage the risk of mass defaults, the bank packages these loans and sells them to a third-party financial institution, thereby diversifying its risk.
This risk management strategy is an example of:
(A) Risk Avoidance
(B) Risk Retention
(C) Risk Optimization
(D) Risk Transfer

May/June 2024

67. Read the following scenario and answer the question that follows.
Eta Bank is implementing the Enterprise Risk Management (ERM) framework. Before the management can identify potential events that

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may affect the bank, they realize a foundational step is missing. They have established the internal environment but haven't determined what the entity strives to achieve.

Which ERM component must management execute next before identifying potential events?

(A) Control Activities
(B) Information and Communication
(C) Risk Response
(D) Objective Setting

Oct/Nov 2008

68. Read the following scenario and answer the question that follows.

Zeta Bank's management team is proposing a high-risk, high-return expansion into unregulated cryptocurrency markets. Before proceeding, they must seek approval from the supreme decision-making body of the bank, which sets the overall strategic direction.

Which body is responsible for setting the risk tolerance limits and making the ultimate decision on this expansion?

(A) The Board of Directors
(B) The Executive Management
(C) The Risk Management Committees
(D) The Internal Audit Functionaries

May/June 2006

69. Read the following scenario and answer the question that follows.

Epsilon Bank has owned funds aggregating to ₹ 8 billion. The board of directors has fixed the aggregate risk limit at 25 percent of owned funds. Out of this overall limit, ₹ 1.2 billion is allotted for credit risk, ₹ 500 million for market risk, and ₹ 200 million for operational risk.

What is the balance amount that can be earmarked for residual risks?

(A) ₹ 200 million
(B) ₹ 100 million
(C) ₹ 50 million
(D) ₹ 1 billion

Oct/Nov 2017

70. Read the following scenario and answer the question that follows.

Theta Bank has well-established board policies, an active executive management team, and line functionaries operating within prescribed ceilings. However, the regulatory body noted that the bank lacks an independent review of its critical control systems and risk management processes.

To fill this gap and act as the third line of defence, which group of functionaries must Theta Bank deploy to evaluate the effectiveness of risk assessments?

(A) Risk Management Committees
(B) Internal Audit Functionaries
(C) Operating Management
(D) Top Management

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ANSWERS

1. (D) Rating models
Rating models serve as essential qualitative or quantitative tools to evaluate the creditworthiness of borrowers. These models categorize entities based on their financial health and probability of default. By assigning a specific grade or score, they effectively indicate the level of risk associated with a particular counterparty, allowing financial institutions to differentiate between various exposure levels efficiently.

2. (C) Risk sharing means that the risk is completely avoided by transferring it to a third party.
Risk sharing involves distributing the potential financial burden of a loss or the rewards of a gain among multiple parties. While tools like insurance and outsourcing help manage risk, they do not result in complete avoidance. Risk avoidance implies a total withdrawal from an activity, whereas sharing maintains exposure while leveraging third parties to mitigate potential impacts.

3. (C) The risk levels an entity assumes to meet strategic objectives.
Risk appetite represents the amount and type of risk an organization is willing to pursue or retain to achieve its strategic objectives. It serves as a guiding framework for decision-making across the entity. By defining these boundaries, management ensures that business activities align with the firm's overall mission and the expectations of various stakeholders and regulatory requirements.

4. (C) Augmenting financial metrics with quality and process measures.
The balanced scorecard approach integrates traditional financial indicators with non-financial performance measures. This methodology focuses on four perspectives: financial, customer, internal processes, and learning and growth. By augmenting financial metrics with quality and process measures, organizations gain a holistic view of performance. This ensures that risk management efforts support long-term sustainability rather than focusing solely on immediate profits.

5. (B) They are opportunities that support value creation.
Within an enterprise risk management framework, internal or external events can have either negative or positive impacts. Events with a negative impact represent risks, while those with a positive impact are viewed as opportunities. These opportunities are funneled back into the strategy-setting process, allowing management to take actions that support value creation and achieve organizational goals.

6. (B) Managing uncertainty to increase stakeholder value within the entity.
Enterprise risk management is built on the premise that every organization exists to provide value for its stakeholders. All entities face uncertainty, and the challenge for management is to determine how much uncertainty to accept. By managing uncertainty effectively, firms can enhance their capacity to build value, minimize losses, and ensure the achievement of their strategic business objectives.

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7. (B) Proactively identifying, analyzing, and taking steps to reduce risks.
In the financial sector, risk management involves the proactive identification and analysis of potential threats to an institution's capital or earnings. It requires taking deliberate steps to mitigate or reduce these risks to acceptable levels. This process is continuous and essential for ensuring that the organization remains stable and resilient against market fluctuations, credit defaults, and operational failures.

8. (B) Controls within enterprise risk management can be circumvented by collusion of two or more people.
Enterprise risk management provides reasonable assurance rather than absolute certainty. Human judgment can be faulty, and breakdowns can occur due to simple errors

or mistakes. Furthermore, internal controls designed to mitigate risks can be bypassed if two or more individuals collude. Additionally, management often has the authority to override established policies, which represents a significant limitation of the framework.

9. (B) Risk appetite is a static concept written in tablets of stone that remains unchanged for the rest of the year.
A risk appetite statement must be a dynamic and measurable concept that provides a meaningful yardstick for an organization. It is not a static document; rather, it should be reviewed and adjusted as market conditions or business strategies change. It often encompasses a range of appetites for different risk types and typically includes components related to both risk and control.

10. (C) It discourages good clients while attracting relatively bad ones.
Failure to differentiate between various risk profiles leads to adverse selection. When a bank under-prices risk for risky customers and over-prices it for safe ones, it inadvertently drives away high-quality borrowers who seek fairer terms. Consequently, the portfolio becomes dominated by higher-risk clients, which increases the overall vulnerability of the bank's earnings and its long-term financial health.

11. (A) 1, 4, 3, 2
The risk identification process begins with gaining thorough knowledge of the business environment. Once the context is understood, reviewing past experiences provides insights into historical vulnerabilities. This knowledge facilitates the identification of unwanted events and emerging threats that could disrupt operations. Finally, documenting these identified risks in a register ensures they are systematically tracked, analyzed, and managed across the enterprise.

12. (C) Board of Directors
The Board of Directors holds the ultimate responsibility for the governance, management, and performance of a company. This body sets the overall strategic direction and determines the institution's risk appetite. By overseeing the risk management framework, the board ensures that senior management implements effective policies and systems to identify, measure, and control risks in the best interest of stakeholders.

13. (A) The board members must take part in day-to-day operations and activities to effectively manage risks.
The Board of Directors focuses on high-level governance and oversight rather than day-to-day operations. Their role includes setting risk tolerance limits and approving broad policies. While they meet regularly with senior management to review performance and accountability, they must remain independent of daily activities. Effective governance requires the board to evaluate risk assessment methods and organizational structures from a strategic perspective.

14. (C) The risk management policy is a general document on the bank's risk management philosophy and risk appetite.
A bank's risk management policy serves as a foundational document outlining its risk philosophy and appetite. It provides a reference manual for all personnel, detailing the strategies for identifying and measuring various risks. This policy must be flexible enough to adapt to changing market conditions and should clearly link the bank's risk management activities to its broader business objectives.

15. (D) To make informed decisions on pricing.
Line functionaries operate at the front line of business activities where risks are directly assumed. It is essential for them to gather detailed market information to evaluate the potential impact of various variables. This data allows them to price products and services accurately, ensuring that the returns adequately compensate the bank for the specific risks associated with each unique transaction.

16. (A) Shared norms influencing group risk behavior and decisions.
Risk culture is defined as the shared values, attitudes, and norms that characterize how an organization views and handles risk. It significantly influences the behavior of individuals and groups when making business decisions. A strong risk culture ensures that every employee understands the institution's

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risk appetite and acts in accordance with established policies, promoting collective responsibility and ethical conduct.

17. (A) The specific names of employees responsible for the risk occurrence
A risk register is a comprehensive tool used to document identified risks and their potential impacts. It typically includes the risk category, potential consequences, and existing internal controls designed to minimize likelihood. While it tracks the nature and causes of threats, it does not usually record the specific names of individual employees, focusing instead on structural and systemic risk factors.

18. (A) Strategic, Operations, Reporting, and Compliance
The Enterprise Risk Management framework categorizes an entity's objectives into four distinct areas. Strategic objectives focus on high-level goals aligned with the mission. Operations objectives relate to the efficient use of resources. Reporting objectives ensure the reliability of internal and external information. Compliance objectives focus on adherence to applicable laws and regulations, providing a comprehensive structure for managing various risks.

19. (D) The risk register only documents risks that have materialized and resulted in quantitative losses.
The risk register is a proactive tool that documents both potential and materialized risks. It serves as the primary output of risk identification exercises, capturing how and why risks might occur. By recording existing internal controls and potential impacts, it allows management to visualize threats before they lead to losses. This enables the institution to implement preventative measures and mitigation strategies.

20. (A) Taking collateral to lower potential losses from a default.
Risk reduction involves taking specific actions to decrease the likelihood or severity of a potential loss. An example in banking is requiring collateral for a loan, which provides a secondary source of repayment if the borrower defaults. This strategy allows the institution to continue the business activity while implementing measures that minimize the financial impact of an adverse event occurring.

21. (A) 3, 1, 4, 2
In an enterprise risk management framework, the process begins with objective setting to align goals with the entity's mission. Once objectives are established, management identifies internal and external events that could affect their achievement. These identified events are then assessed for likelihood and impact. Finally, the organization selects an appropriate risk response to manage the exposure within its established appetite.

22. (B) Residual risks
Banks establish aggregate risk limits as a percentage of owned funds to maintain financial stability. After allocating specific portions of this limit to primary categories like credit, market, and operational risks, a buffer often remains. This unallocated balance is typically earmarked for residual risks. These are risks that remain after considering the effectiveness of controls and specific risk treatments implemented.

23. (D) To provide decision-support and data maintenance for management.
The Management Information System plays a crucial role in risk management by maintaining high-quality data and providing decision-support tools. It processes operational data to generate reports that help management monitor risk exposures and performance against established limits. By facilitating the flow of timely and accurate information, the system enables informed decision-making across all levels of the organizational structure and hierarchy.

24. (D) It should replace the internal audit function with automated reporting systems.
A robust risk management architecture must provide an integrated approach that captures the full range of risks faced by a bank. It includes procedures for identifying, measuring, and monitoring risks while assessing capital requirements. Although automation improves efficiency, it should never replace the internal audit function. Internal audit remains essential

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as an independent third line of defence to review control effectiveness.

25. (B) Concentrating decision-making power in single individuals.
Lessons from financial crises emphasize the importance of broad oversight and avoiding the concentration of power in single individuals. Organizations must ensure that incentive structures do not encourage imprudent behavior. Employees at all levels should understand how their activities contribute to the overall risk profile. Furthermore, risk measures must be integrated into management reporting to ensure transparency and informed decision-making throughout.

26. (D) Reducing risk exposure and the likelihood of an adverse incident.
Risk mitigation refers to the systematic process of reducing the likelihood or the impact of adverse events. It involves implementing controls, diversifying portfolios, or taking collateral to lower the institution's overall exposure. This ongoing management activity ensures that risks are kept within the established appetite of the organization, allowing the business to pursue objectives while minimizing potential financial and operational disruptions.

27. (A) The Risk Management Function
The risk management function should be institutionalized as an independent body within the bank to supervise overall risk activities. This function must be separate from the line departments that assume risks to avoid conflicts of interest. Its primary role is to develop frameworks, monitor exposures against limits, and provide objective reports to the board and senior management regarding the bank's profile.

28. (A) It addresses interdependencies through integrated reporting.
Enterprise risk management is superior to silo-based strategies because it takes a holistic, portfolio-level view of risk. Unlike silos, which manage risks in isolation, this framework recognizes and addresses the interdependencies between different risk types. Through integrated reporting, it provides a comprehensive picture of the organization's total exposure, enabling management to make better-informed decisions that enhance overall stakeholder value.

29. (C) Eliminating the need for maintaining liquid cash flows
Effective risk management provides numerous benefits, including the better achievement of business objectives and reduced earnings volatility. It helps institutions balance risk and reward while gaining a competitive advantage through better pricing. However, it does not eliminate the need for maintaining liquid cash flows. On the contrary, managing liquidity risk is a core component of ensuring that an institution can meet obligations.

30. (D) Employee risk taking should be premised on the bank's risk appetite and be in line with the approach to risks managed by the bank.
In a healthy risk culture, employee behavior must align with the institution's overall risk appetite and management philosophy. Motivation is driven by ensuring that performance management and accountability frameworks reward prudent risk-taking. This alignment ensures that individuals at all levels understand the boundaries within which they must operate, thereby protecting the bank from unauthorized or excessive exposures that could jeopardize stability.

31. (C) Reviewing assessments to provide feedback for internal control.
The internal audit function acts as the third line of defence by providing an independent and dispassionate review of the risk management framework. Its primary objective is to evaluate the effectiveness of internal controls and risk assessments. By providing feedback and recommendations for improvement, internal auditors help ensure that the organization's risk management processes are robust, compliant, and functioning as intended.

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32. (B) (II), (III), (IV), and (V) only
Effective risk culture is driven by leadership from the Board and senior management. It requires personnel to adhere to ethical principles and avoid imprudent risk-taking. Structured communication channels and a climate where employees can constructively challenge decisions are also vital. While recruitment

should consider risk competence, ignoring a candidate's past experience is incorrect, as it is a crucial indicator of future behavior.

33. (C) P-2, Q-4, R-1, S-3
The Board of Directors sets the overall strategic direction and risk limits. Executive management evaluates the overall risks faced by the bank to protect its interests. Line functionaries are responsible for day-to-day implementation and operating within their specific authority levels. Finally, internal audit functionaries provide an independent review of risk assessments and internal controls to ensure the framework remains effective and objective.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Enterprise risk management provides reasonable assurance regarding reporting reliability and regulatory compliance because these objectives are largely within the entity's direct control. Management can implement specific systems and procedures to ensure accuracy and adherence to laws. Unlike strategic or operational goals, which may be influenced by external factors, compliance and reporting can be managed effectively through robust internal governance and oversight.

35. (C) Statement I is correct, but Statement II is incorrect.
Securitization and insurance are standard methods for transferring risk, with insurance serving as a strategy to manage losses after an event occurs. However, the complete elimination of risk is virtually impossible in the banking business. Institutions must accept that risk is inherent in financial activities; therefore, the goal of risk management is to mitigate and manage these exposures effectively.

36. (A) Use risk-weighted performance measures in bonuses.
To align behavior with a firm's risk culture, compensation must reflect the level of risk taken to generate profits. Implementing risk-weighted performance measures ensures that bonuses are adjusted for the potential impact of unhedged positions. This discourages excessive risk-taking for short-term gains and encourages employees to consider the long-term stability and risk appetite of the institution when making trading decisions.

37. (A) P-2, Q-4, R-1, S-3
Risk competence involves recruitment, skills, and continuous learning. Organization covers the structural elements like policies, strategy, and ethical values. Relationships are built through leadership, effective communication, and the ability to challenge ideas constructively. Motivation is driven by accountability, performance management, and a strong risk orientation. Together, these components create a comprehensive framework that defines and supports a robust organizational risk culture.

38. (D) (I), (II), and (IV) only
Risk limits are vital for determining the volume and quality of business an institution can accept. These limits are typically established as a percentage of total capital and are influenced by business opportunities, market competition, and historical loss experiences. They are not allocated hypothetically; instead, they must be based on a rigorous analysis of the bank's business mix and risk-bearing capacity.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Risk limits are essential components of a sound risk management program because they provide necessary boundaries for business activities. While strategic plans dictate the direction of growth, limits define the points at which an institution must stop or re-evaluate its exposure. This ensures that the bank does not exceed its risk-bearing capacity, maintaining stability even when pursuing aggressive business expansion goals.

40. (D) Risk Response - Analyzing risks purely on an inherent basis without selecting any responses.
Risk response involves management selecting specific actions, such as avoiding, accepting, reducing, or sharing risks, to align exposures with the entity's appetite. This process requires a detailed analysis of both inherent and residual risks. Simply analyzing risks on an inherent basis without choosing a response is

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insufficient, as the goal of this component is to develop an effective strategy for management.

41. (B) The risk category and cause of risk
A standard risk register must include several key elements to be effective. While Gamma Bank recorded the potential financial impact and existing controls, it missed the mandatory risk category and the specific cause of the risk. Understanding why a risk might happen is crucial for developing appropriate mitigation strategies and ensuring that the threat is accurately classified within the bank's framework.

42. (A) P-3, Q-4, R-1, S-2
The internal environment sets the tone for risk perception within an organization. Risk assessment involves analyzing the likelihood and impact of potential threats to determine management strategies. Control activities are the policies and procedures established to ensure risk responses are executed. Finally, information and communication ensure that relevant data is identified and shared effectively so personnel can fulfill their risk-related responsibilities.

43. (B) (I), (II), and (IV) only
A risk management policy serves as a manual for all personnel and outlines the connection between risk strategies and the business plan. It must clearly define the procedures for risk identification and measurement. While it provides a high-level philosophy, specific operational details for loans and investments are usually covered in separate, more detailed functional policies rather than the broad risk policy.

44. (D) (I) and (II) only
Enterprise risk management is applied across all levels of an organization to manage uncertainty within its established risk appetite. It takes a comprehensive portfolio view of risk to protect and enhance stakeholder value. However, it can only provide reasonable assurance regarding the achievement of objectives. No framework can provide absolute assurance due to inherent limitations like human error, judgment failures, and collusion.

45. (C) Silo-based risk management
Silo-based risk management occurs when departments operate independently without sharing information. This approach fails to account for interdependencies and aggregate exposures across the organization. Alpha Bank's failure to recognize that industry volatility flagged by market risk would impact credit assessments is a classic example of how fragmented systems can lead to unforeseen and excessive losses due to a lack of integration.

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46. (B) P-2, Q-1, R-4, S-3
Risk avoidance involves withdrawing from or not becoming involved in activities that present threats. Reduction focuses on optimizing and mitigating the severity or likelihood of risks. Sharing involves diversifying or transferring risk through tools like insurance or outsourcing. Retention occurs when an organization chooses to accept and contain the risk internally, often because the exposure is minimal or the cost-benefit favors acceptance.

47. (D) Assertion (A) is false, but Reason (R) is true.
A silo-based risk management approach is ineffective at tracking counterparty risk because business units operate in isolation. When different departments use disparate systems and methodologies, quantifying the total aggregate exposure for a single entity becomes nearly impossible. This fragmented view prevents the organization from seeing the "big picture," which is essential for managing concentration risk and ensuring overall financial stability.

48. (B) Reduced Volatility in Earning - Focusing on short-term profitability while deliberately ignoring potential bubbles.
Risk management aims to reduce earnings volatility by providing stability and predictability in financial performance. This is achieved by identifying and managing long-term threats and bubbles rather than ignoring them for short-term gain. By balancing risk and reward and maintaining healthy liquidity, institutions can achieve a competitive advantage and ensure they can meet their immediate obligations regardless of market conditions.

49. (A) (I), (II), (IV), and (V) only
Risk management committees, comprising senior management and business heads, support the oversight of the institution's risk profile. They monitor the risk appetite and review performance under various scenarios, including stress tests. These committees are not independent of business strategy; instead, they ensure that risk management is integrated with corporate objectives. They also follow up on audit recommendations to improve control systems.

50. (C) (I) and (II) only
Executive management is responsible for implementing the risk policies approved by the board and evaluating overall risks to protect the bank's interests. This group reports directly to the Board of Directors. However, they do not act as the supreme decision-making body; that role belongs to the Board. Their focus is on operationalizing the strategic direction set by the board through daily management.

51. (D) Accountability
Accountability is a core sub-component of motivation in a risk culture framework. It dictates that individuals must be held responsible for their actions and the risks they take. When a manager ignores the established risk appetite to meet personal targets, they must face consequences. This ensures that everyone within the organization understands that adherence to risk policies is mandatory and tied to their performance evaluation.

52. (D) MIS - Processing control data to produce necessary information reports.
A bank's risk management architecture includes various elements like identification, monitoring, and reporting systems. The Management Information System is specifically designed to process control data and generate the reports required for effective decision-making. While capital allocation and risk identification are also critical, the MIS provides the necessary infrastructure to handle data and communicate risk levels across the organization's different management levels.

53. (D) Statement I is incorrect, but Statement II is correct.
Risk measurement tools aim to quantify potential losses, which include both expected and unexpected components. Rating models are primarily used to indicate the level of risk associated with a borrower or facility. In contrast, statistical models are used to measure the potential quantitative loss. Understanding both the level of risk and the potential financial impact is necessary for a comprehensive assessment.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Adverse selection occurs when a bank fails to differentiate between risky and safe borrowers. By under-pricing high risks and over-pricing low risks, the bank inadvertently discourages high-quality clients while attracting those more likely to default. This happens because the pricing does not reflect the actual underlying risk, leading to a portfolio that is increasingly composed of less reliable and riskier customers.

55. (A) (I), (III), and (IV) only
The Board of Directors sets the bank's strategic direction, fixes risk tolerance limits, and evaluates risk assessment methods. They are also responsible for reviewing the performance and accountability of senior management. While they oversee the governance of the bank, they do not act as internal audit functionaries themselves; that role is performed by a separate, independent group dedicated to auditing.

56. (D) P-2, Q-1, R-4, S-3
In the ERM framework, strategic objectives are high-level goals that support the entity's mission. Operations objectives focus on the efficient and effective use of resources. Reporting objectives are centered on the reliability of the information provided to stakeholders. Compliance objectives ensure the organization adheres to all relevant laws and regulations. Together, these categories provide a comprehensive roadmap for managing institutional risks effectively.

57. (A) Operational risk and financial (credit) risk
This scenario demonstrates the interdependency between operational risk and credit risk.

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Flawed loan documentation is an operational failure, often due to inadequate processes or human error. This failure leads to a credit risk event when the borrower defaults and the bank cannot recover funds through collateral. This highlights how weaknesses in internal operations can directly contribute to severe financial losses from lending activities.

58. (C) Statement I is correct, but Statement II is incorrect.
Risk monitoring and risk control are complementary processes, with monitoring typically providing the data needed for control actions. Effective monitoring requires independence to ensure objectivity. Therefore, the monitoring group should consist of personnel who are not directly responsible for the operational duties they are reviewing. This separation is essential for identifying potential issues without the bias of those involved in the transactions.

59. (C) (I), (III), and (IV), and (V) only
Effective risk management ensures that product pricing reflects underlying risks and that transfer strategies optimize the portfolio's return. It also requires that performance incentives align with risk objectives and that major decisions, like mergers, explicitly consider risk factors. However, capital should be allocated to projects with the highest possible risk-adjusted returns, not the lowest, to maximize the value provided to the stakeholders.

60. (B) (I) and (III) only
Risk measurement tools, including rating models, must identify deteriorating financial strength in borrowers to predict potential defaults. Regulatory standards also require separate models for credit, market, and operational risks due to their unique characteristics. These models cannot be standard across all banks; they must be tailored to each institution's specific size, business mix, and individual risk profile to be effective.

61. (C) Avoiding day-to-day operations to prevent conflicts.
The Board of Directors is responsible for high-level governance and oversight, which requires maintaining independence from daily business activities. When a board member participates in day-to-day operations, especially in the credit department while holding shares in a competitor, it creates a conflict of interest. Effective risk management requires the board to remain objective to supervise management and set the strategic direction.

62. (A) Risk Reduction
Risk reduction involves implementing measures to decrease the likelihood or severity of a loss without completely avoiding the activity. By using rigorous pre-sanction due diligence and demanding high-quality collateral, Delta Bank reduces the probability of default and the potential financial impact if a default occurs. This allows the bank to continue lending to the SME sector while maintaining risk within acceptable levels.

63. (C) Utilizing flow charts and operational models.
For complex products where the consequences of failure are catastrophic, basic checklists or general judgments are insufficient. Flow charts and operational models provide a detailed, systematic way to identify potential failure points and analyze the interdependencies within the product's lifecycle. While more intensive, this approach is the most effective way to ensure that all significant risks are identified and managed proactively.

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64. (C) Risk Assessment
Risk assessment is the component of the ERM framework where identified threats are analyzed for their likelihood and potential impact. This process involves evaluating both inherent risk, which exists before any controls, and residual risk, which remains after existing controls are considered. This analysis provides the necessary foundation for management to determine how each risk should be prioritized and what response strategy is appropriate.

65. (B) Limits must link to historical data and business mix.
Risk limits should not be allocated arbitrarily or equally across different risk types. Instead, they must be based on a rigorous analysis of the bank's business mix, historical loss experiences, and strategic priorities. Allocating limits on a

hypothetical basis ignores the actual exposure levels and risk profiles of different departments, potentially leaving the bank vulnerable to significant losses in areas where risks are higher.

66. (D) Risk Transfer
Risk transfer is a strategy where the financial burden of a risk is moved to another party. By packaging and selling sub-prime mortgage loans to another institution, Delta Bank effectively transfers the credit risk associated with those loans. This allows the bank to reduce its exposure to potential defaults while diversifying its portfolio, leveraging market mechanisms to manage risk levels that might otherwise exceed its appetite.

67. (D) Objective Setting
In the ERM framework, objective setting must occur before management can identify events that could impact their achievement. While the internal environment establishes the organization's tone, objectives provide the specific goals that the entity strives to reach. Without clear objectives, it is impossible to determine which internal or external events represent threats or opportunities, making subsequent identification and assessment activities ineffective.

68. (A) The Board of Directors
The Board of Directors is the supreme decision-making body of a bank and is responsible for setting the overall strategic direction and risk tolerance limits. Decisions regarding high-risk expansions, such as entering unregulated markets, fall under their ultimate oversight. While other committees provide analysis and recommendations, the board must ensure that such moves align with the long-term interests of the bank and its stakeholders.

69. (B) ₹ 100 million
The aggregate risk limit is calculated as twenty-five percent of the eight billion rupees in owned funds, totaling two billion rupees. Summing the specific allocations for credit, market, and operational risks results in one billion nine hundred million rupees. Subtracting this total from the aggregate limit leaves one hundred million rupees. This remaining balance is designated for residual risks, providing a necessary buffer for the bank.

70. (B) Internal Audit Functionaries
Internal audit functionaries act as the third line of defence in a bank's organizational structure. Their primary role is to provide an independent and objective evaluation of the risk management framework and internal control systems. By reviewing the effectiveness of risk assessments performed by other departments, they ensure that the bank's processes are robust and that governance standards are maintained across all operations.

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CHAPTER 04

Asset Liability Management and Interest Rate Risk on Banking Book

Oct/Nov 2023

1. In assessing a bank's interest rate risk exposure, the earnings perspective differs from the economic value perspective primarily in which of the following ways?

(A) The earnings perspective focuses on net interest income sensitivity, whereas the economic value perspective reflects the sensitivity of a bank's net worth.

(B) The earnings perspective is used exclusively for the banking book, whereas the economic value perspective is applied to the trading book.

(C) The earnings perspective measures mark-to-market variations of off-balance items, while the economic value perspective focuses on capital ratios.

(D) The earnings perspective focuses on near-term reported interest income, whereas the economic value perspective evaluates the present value of all cash flows.

May/June 2011

2. Which of the following represents the correct formula for calculating the Net Interest Margin (NIM)?

(A) $NIM = \frac{\text{Rate Sensitive Assets} - \text{Rate Sensitive Liabilities}}{\text{TotalAssetstimes}} \times 100$

(B) $\text{NIM} = \frac{\text{Total InterestIncome} - \text{Total Interest Expense}}{\text{TotalEquity}} \times 100$

(C) $\text{NIM} = \frac{\text{Net Interest Income}}{\text{Total Earning Assets}} \times 100$

(D) $\text{NIM} = \frac{\text{Spread} \times \text{Rate Sensitive Assets}}{\text{Total Liabilities}} \times 100$

Oct/Nov 2012

3. The ALM process is fundamentally based on three pillars. Which of the following correctly identifies the components of the "ALM Organization" pillar?

(A) Risk policies and tolerance limits, Risk parameters, and Risk identification.

(B) Measurement of liquidity risk, Capital planning, and Transfer pricing.

(C) Top-level involvement, Structure and responsibilities.

(D) ALM Information systems, Stress testing, and Back testing.

May/June 2015

4. Which of the following is not recognized as a direct factor affecting the Net Interest Income (NII) of a bank?

(A) Periodic changes in the general level of market interest rates.

(B) Changes in the underlying composition or mix of bank assets and liabilities.

(C) Changes in the historical cost and annual depreciation of physical fixed assets.

(D) Changes in the total volumes of assets and liabilities currently outstanding.

Oct/Nov 2013

5. Which of the following statements regarding Yield Curve Risk is incorrect?

(A) It arises from changes in the relationship among interest rates of different maturities of the same index or market.

(B) It is exclusively concerned with the imperfect correlation in the adjustment of rates earned and paid on completely different benchmark indices.

(C) It involves the economic impact when the slope and shape of the yield curve flattens, steepens, or inverts.

(D) It can amplify the effect of maturity mismatches, leading to sharp declines in economic value even if positions are hedged against parallel movements.

May/June 2008

6. Standard regulatory frameworks often prescribe various time buckets for the calculation of the Traditional GAP Analysis (TGA). Which of the following is not typically

NODIA

one of the prescribed time buckets under standard banking guidelines?
(A) 1-28 days
(B) Over 4 years and up to 5 years
(C) Over 6 months and up to 1 year
(D) Over 10 years and up to 15 years

Oct/Nov 2017

7. Which of the following best defines Asset Liability Management (ALM) in the context of banking?
(A) The periodic assessment of a bank's capital adequacy levels to ensure full compliance with Basel III regulatory requirements.
(B) The strategic management of a bank's assets and liabilities to achieve financial objectives and risk tolerance.
(C) The daily trading strategies used by treasury departments to maximize short-term arbitrage gains from currency markets.
(D) The systematic auditing process conducted by external regulatory bodies to verify the accuracy of non-performing assets.

May/June 2006

8. Consider the following statements regarding Optionality Risk:
I It arises from the options embedded in many bank assets, liabilities, and off-balance-sheet portfolios.
II A bank that writes options to its customers generally faces limited downside risk and unlimited upside reward.
III Option holders face limited downside risk (the premium paid) and unlimited upside reward.
IV Instruments with embedded options include non-maturity deposit instruments and loans with prepayment rights.
Which combination of the statements is correct?
(A) (I), (II), and (III) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2008

9. A bank presents the following data for a specific time bucket: Rate Sensitive Assets (RSA) = ₹1,200 crores, Rate Sensitive Liabilities (RSL) = ₹1,500 crores. If interest rates uniformly decrease by 1.5% across all maturities, what will be the expected change in Net Interest Income (ΔNII) for this time bucket?
(A) Decrease of ₹4.50 crores
(B) Increase of ₹4.50 crores
(C) Decrease of ₹22.50 crores
(D) Increase of ₹22.50 crores

May/June 2024

10. Consider the following statements regarding Interest Rate Risk (IRR) Policies:
I IRR policies should be aligned with the board's IRR strategy and risk appetite.
II IRR policies typically include standards for valuing positions but exclude the frequency of IRR measurement.
III IRR policies mandate reporting requirements detailing the reports to be submitted to regulators, senior management, and the Board of Directors.
Which combination of the statements is correct?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2021

11. A bank assesses its Interest Rate Sensitivity Statement and determines a cumulative GAP for one year of +₹1,200 crores. If the central bank suddenly reduces the policy rate by 75 basis points and this cut is entirely reflected in the market, what will be the expected impact on the bank's earnings?
(A) Increase of ₹9.00 crores
(B) Decrease of ₹4.50 crores
(C) Increase of ₹0.90 crores
(D) Decrease of ₹9.00 crores

May/June 2013

12. Which of the following represents the most appropriate primary purpose of the Asset-Liability Committee (ALCO)?
(A) To conduct independent audits of investment portfolios and derivative exposures for mandatory statutory reporting purposes.
(B) To approve large-value corporate credit proposals and review specific provisioning requirements for non-performing loans.
(C) To identify, manage, and control a bank's

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balance sheet risks and capital in execution of chosen business strategies.

(D) To recruit, train, and assess operational staff responsible for managing the bank's daily treasury and liquidity operations.

Oct/Nov 2015

13. In the context of GAP analysis, which of the following is the most appropriate classification for a loan whose interest rate is tied to the Marginal Cost of Funds Based Lending Rate (MCLR) which undergoes immediate repricing when the MCLR is reset monthly?

(A) The full amount of the loan is shown as rate sensitive for the 0 to 30 days time interval.

(B) Only the interest accrued is shown as rate sensitive for the 0 to 30 days interval.

(C) The loan is treated as fixed-rate and classified into the time bucket corresponding to its final principal maturity.

(D) The loan is classified into the time bucket matching the average deposit duration of the bank.

May/June 2020

14. Identify the correct pair regarding the basic shapes of the yield curve and their implications.

(A) Flat yield curve - Indicates strong steady economic expansion and rising inflation.

(B) Normal upward sloping curve - Indicates short-term rates are expected to rise and fall again in the medium term.

(C) Inverted yield curve - Suggests yields will be lower at the longer end, often associated with recessionary conditions.

(D) Humped yield curve - Sends a clear signal of long-term economic stability and lack of volatility.

Oct/Nov 2005

15. Arrange the following steps involved in preparing a Traditional GAP analysis in the correct chronological order.

I Calculate the periodic and cumulative GAP by finding the difference between RSA and RSL.

II Assess the Net Interest Income given the interest rate scenario.

III Form an interest rate forecast.

IV Decide a series of sequential time intervals (buckets).

V Group assets and liabilities into time buckets according to the time until first repricing.

(A) (III), (IV), (V), (I), (II)

(B) (IV), (III), (V), (II), (I)

(C) (III), (V), (IV), (I), (II)

(D) (V), (IV), (III), (I), (II)

May/June 2017

16. What are the two primary types of imbalances generated by the financial intermediation activity involving asset liability transformation?

(A) Imbalances between maturity/interest sensitivities of funding and loans, and between total funds collected and lent.

(B) Imbalances between short-term liquidity needs and long-term solvency goals, and between equity capital and total debt.

(C) Imbalances between domestic currency deposits and foreign currency loans, and between retail liabilities and corporate assets.

(D) Imbalances between off-balance sheet exposures and on-balance sheet assets, and between risk-weighted assets and capital.

Oct/Nov 2024

17. The following question consists of two statements, an Assertion (A) and a Reason (R).

Assertion (A): A bank with a negative GAP will experience a decline in its Net Interest Income (NII) if the level of interest rates rises uniformly across the market.

Reason (R): In a negative GAP position, more liabilities than assets are repriced at the higher rates, causing interest expenses to rise faster than interest income.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

May/June 2010

18. Regarding regulatory guidelines on governance, measurement, and management of Interest

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Rate Risk in Banking Book (IRRBB), what is the stipulated return submission frequency and commencement date for Domestic Systemically Important Banks (D-SIBs)?
(A) Quarterly, from March 2023
(B) Monthly, from March 2023
(C) Quarterly, from June 2023
(D) Annually, from March 2023

Oct/Nov 2011

19. Consider the following statements regarding the Traditional GAP Analysis:
I A bank with a positive GAP is liability sensitive because more liabilities than assets are subject to repricing.
II A bank with a negative GAP is liability sensitive, and its Net Interest Income generally declines if all interest rates rise uniformly.
Which of the following is correct?
(A) Statement (I) is true and Statement (II) is false.
(B) Statement (I) is false and Statement (II) is true.
(C) Both Statement (I) and Statement (II) are true.
(D) Both Statement (I) and Statement (II) are false.

May/June 2009

20. How is Basis Risk most accurately defined within the framework of interest rate risk management?
(A) Risk from imperfect correlation in the adjustment of rates earned and paid on instruments with similar repricing traits.
(B) Potential loss arising from an inability to liquidate assets quickly without suffering a substantial price concession.
(C) Exposure arising from timing differences in the maturity and repricing of bank assets, liabilities, and off-balance-sheet items.
(D) Risk associated with the exercise of explicit and embedded options by customers in a changing interest rate environment.

Oct/Nov 2019

21. A bank's Interest Rate Sensitivity Statement reveals a periodic GAP of -₹150 crores for the 1-28 days bucket, and a periodic GAP of +₹400 crores for the 29 days to 3 months bucket. What is the cumulative GAP up to 3 months?
(A) -₹150 crores
(B) +₹400 crores
(C) +₹250 crores
(D) +₹550 crores

May/June 2025

22. Consider the following statements regarding the scope and responsibility of ALCO concerning Capital:
I Recommend changes in the bank's risk policy and drive action as required.
II Monitor long-term Risk Weighted Assets (RWA) trends and oversee actions to optimize RWA levels.
III Monitor and review capital usage and return on capital for each business against targets.
IV Review capital budgets/forecasts by business units to ensure compliance with Board strategy.
V Approve the allocation of capital between the businesses where appropriate.
Which combination of the above statements is correct?
(A) (I), (III), (IV), and (V) only
(B) (II), (III), (IV), and (V) only
(C) (I), (II), (III), and (IV) only
(D) (I), (II), (III), (IV), and (V)

NODIA

Oct/Nov 2007

23. A bank holds longer-term fixed-rate loans funded by shorter-term variable-rate deposits. If interest rates in the market rise substantially by the time the deposits mature, the bank is primarily exposed to which of the following?
(A) Reinvestment risk
(B) Basis risk
(C) Optionality risk
(D) Refinancing risk

May/June 2014

24. A bank has a portfolio consisting of ₹800 crores in earning assets yielding 7% and ₹800 crores in interest-bearing liabilities costing 4%. If the bank decides to double its portfolio size with identical composition and rates, what is the net effect on the Net Interest Margin (NIM)?
(A) NIM doubles to reflect the significant increased volume of net interest earnings.
(B) NIM is halved due to the rapid expansion

of the total underlying asset base.
(C) NIM increases by an amount directly proportional to the absolute increase in NII.
(D) NIM remains constant as both interest spread and proportionality are maintained.

Oct/Nov 2016

25. Which of the following statements correctly outlines the expected repricing principle for a deposit linked to the Mumbai Interbank Offered Rate (MIBOR) that resets every 90 days, despite having a total maturity of 3 years?
(A) The deposit is classified as rate sensitive for the 3-year time bucket because the principal maturity governs the final settlement.
(B) The deposit is classified as rate-sensitive in the 1-90 days time bucket because the interest rate is required to be reset at prescribed intervals.
(C) The deposit is classified as non-rate sensitive because it is a fixed-term liability.
(D) The deposit is apportioned equally across all time buckets up to 3 years to reflect average repricing probability.

May/June 2018

26. Regarding the composition of the Asset-Liability Committee (ALCO), which of the following designated officials is classified as an attendee rather than a core member?
(A) Chief Executive Officer (CEO/CMD)
(B) General Manager Credit
(C) Chief Financial Officer (CFO)
(D) General Manager Audits & Inspection

Oct/Nov 2022

27. Match the GAP positions in List-I with their corresponding expected impact on Net Interest Income (NII) under different rate scenarios in List-II.
List I: GAP positions
P. Positive GAP, Interest rates decrease
Q. Negative GAP, Interest rates increase
R. Negative GAP, Interest rates decrease
S. Positive GAP, Interest rates increase
List II: Impact on NII
1. NII increases
2. NII decreases
3. NII increases
4. NII decreases
(A) P-2, Q-4, R-1, S-3
(B) P-1, Q-2, R-4, S-3
(C) P-4, Q-3, R-2, S-1
(D) P-3, Q-1, R-4, S-2

May/June 2005

28. Which of the following defines "Repricing risk" in the context of Interest Rate Risk on the Banking Book?
(A) The risk presented by assets and liabilities that reprice at different times and rates when maturity dates and/or repricing dates are not matched.
(B) The risk arising from variations in the movement of interest rates across the maturity spectrum, affecting the slope of the yield curve.
(C) The risk arising from imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar characteristics.
(D) The risk arising from adverse price movements in instruments that respond automatically or by behavioral changes to interest rate fluctuations.

Oct/Nov 2010

29. A bank holds a commercial loan of ₹500 crores with an interest yield of 8% per annum. This is entirely funded by a fixed deposit of ₹500 crores costing 5% per annum. What is the initial Net Interest Income (NII) generated by this transaction over a one-year horizon?
(A) ₹25 crores
(B) ₹40 crores
(C) ₹15 crores
(D) ₹65 crores

May/June 2021

30. Identify the incorrect pair concerning the yield curve indicators.
(A) Normal upward sloping curve - Investors expect yield of long-term securities to be higher in the future.
(B) Steep upward sloping curve - Investors expect rising inflation and stronger economic growth.
(C) Flat yield curve - Sends a signal of uncertainty in the economy.
(D) Humped yield curve - Indicates short-term interest rates are expected to fall

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continuously without rising.

Oct/Nov 2006

31. Who introduced the concept of 'duration' in 1938 as a measure of the effective maturity of any fixed income instrument?
(A) Harry Markowitz
(B) Myron Scholes
(C) Frederick Macaulay
(D) John Maynard Keynes

May/June 2019

32. The following question consists of two statements, an Assertion (A) and a Reason (R).
Assertion (A): While making duration analysis, a standard assumption is that a parallel shift occurs in the yield curve when interest rates change.
Reason (R): In reality, the slope of the yield curve often changes when the level of interest rates changes, exposing the portfolio to yield curve risk not fully captured by standard duration.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2014

33. Consider the following statements regarding the weaknesses of the GAP Analysis:
I It ignores the time value of money and implicitly assumes a book value accounting approach.
II It fully captures the market value effect of interest rate changes on asset and liability values.
III It involves arbitrary setting of time periods which may result in inaccurate measurement of cash flows within a bucket's range.
IV It fails to capture the risk associated with early withdrawal options exercised by depositors.
Which combination of the statements is correct?
(A) (I), (II), and (III) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

May/June 2012

34. Consider the following statements regarding Measurement System Reports:
I System reports typically indicate the change in net income, net interest income, and economic value of equity given various interest rate scenarios.
II Management should have formalized procedures in place for reviewing measurement system results and reporting them to the board or a board committee.
Which of the following is correct?
(A) Statement (I) is true and Statement (II) is false.
(B) Statement (I) is false and Statement (II) is true.
(C) Both Statement (I) and Statement (II) are true.
(D) Both Statement (I) and Statement (II) are false.

Oct/Nov 2025

35. Consider the following statements regarding the Modified Duration GAP (MDG) framework:
I The MDG reflects the degree of duration mismatch in the Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL).
II MDA represents the weighted average of the Modified Duration of items of RSA.
III MDL represents the weighted average of the Modified Duration of items of RSL.
IV The MDG is calculated simply as MDA minus MDL, without any leverage adjustments.
V A larger absolute gap indicates the bank is more exposed to interest rate shocks.
Which combination of the above statements is correct?
(A) (I), (II), (III), and (V) only
(B) (I), (II), (III), (IV), and (V)
(C) (II), (III), (IV), and (V) only
(D) (I), (III), and (V) only

NODIA

May/June 2007

36. Identify the correct pair regarding Back Testing and its operational methodology.

(A) Back Testing execution - Identifying material differences between actual and forecasted income and balance sheet amounts.

(B) Back Testing objective - To exclusively test the speed of internal IT network systems against emerging external cyber threats.

(C) Back Testing variances - Solely determined by interviewing branch managers regarding operational losses and staff productivity.

(D) Back Testing frequency - Conducted once dynamically upon the launch of new core banking software or major hardware upgrades.

Oct/Nov 2018

37. The GAP Ratio is a useful tool as a measure of interest rate risk. Which of the following provides the most appropriate understanding of how the GAP ratio is formulated and interpreted?

(A) It is the GAP divided by Earning Assets or Total Assets; the greater the ratio, the greater the interest rate risk.

(B) It is the cumulative GAP divided by Total Liabilities; a target ratio near 100% indicates minimal risk.

(C) It is the difference between total assets and total liabilities divided by equity; it measures capital adequacy rather than interest rate risk.

(D) It is the ratio of non-interest income to net interest income; a lower ratio suggests high asset sensitivity.

May/June 2023

38. Which of the following correctly describes the implication of a positive Modified Duration Gap (MDG)?

(A) An increase in interest rates will increase the Economic Value of Equity (EVE).

(B) The average duration of liabilities, adjusted for leverage, exceeds the average duration of assets.

(C) The bank is perfectly immunized against any parallel shifts in the yield curve.

(D) A decrease in interest rates will increase the Economic Value of Equity (EVE).

Oct/Nov 2009

39. Match the strategic objectives in List-I with the corresponding on-balance sheet actions in List-II intended to reduce Interest Rate Risk.

List I: Strategic objective

P. Reduce IRR with DGAP > 0 (Shorten asset durations)

Q. Reduce IRR with DGAP > 0 (Lengthen liability durations)

R. Reduce IRR with DGAP < 0 (Lengthen asset durations)

S. Reduce IRR with DGAP < 0 (Shorten liability durations)

List II: On-balance sheet action

1. Issuing longer-term CDs
2. Making fixed-rate loans and selling floating-rate loans
3. Borrowing via shorter-term FHLB advances
4. Making floating-rate loans and selling fixed-rate loans

(A) P-4, Q-1, R-2, S-3

(B) P-1, Q-4, R-3, S-2

(C) P-2, Q-3, R-4, S-1

(D) P-3, Q-2, R-1, S-4

May/June 2016

40. The following question consists of two statements, an Assertion (A) and a Reason (R).

Assertion (A): Bonds with equal duration will have equal interest rate sensitivity and exhibit the same percentage price change for a given change in interest rates.

Reason (R): The proportional change in a bond's price can be directly related to the change in its yield to maturity through its Modified Duration.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

May/June 2022

41. When implementing IRR mitigation techniques using derivatives, the board and

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management should ensure that approved policies specifically address which of the following?

I Analysis of market, liquidity, credit, and operating risks.
II Qualifications of personnel involved in implementing and monitoring hedging strategies.
III Risk limits for hedging activities such as position limits, maturity parameters, and counterparty credit guidelines.
IV Total cessation of all core banking lending activities until hedges are fully executed.

Which combination of the statements is correct?

(A) (I), (II), and (III) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2020

42. Which of the following best defines the conceptual difference between Traditional GAP analysis and Duration GAP (DGAP) analysis?

(A) Traditional GAP captures the market value of equity sensitivity, while DGAP emphasizes the impact on short-term regulatory capital.
(B) Traditional GAP utilizes a liquidation analysis framework, whereas DGAP relies on a going-concern book value accounting approach.
(C) Traditional GAP emphasizes short-term earnings sensitivity, while DGAP focuses on price sensitivity and the present value of cash flows.
(D) Traditional GAP requires complex calculations of weighted cash flows, whereas DGAP measures the absolute mismatch in principal amounts.

Oct/Nov 2023

43. Which of the following is incorrectly stated as a weakness of Duration Analysis?

(A) It requires numerous subjective assumptions such as repricing schedules and early withdrawal potentials.
(B) It inherently captures the exact slope changes and convexity effects of the yield curve during major interest rate cycles.
(C) It assumes that when the level of interest rates changes, interest rates on all maturities change by the same amount (parallel shift).
(D) It requires constant monitoring and recalculation of duration whenever rates change substantially.

NODIA

May/June 2011

44. Arrange the following steps for computing the change in economic value of equity (MVE) due to change in interest rates in the correct sequential order.

I Generate the bucket-wise cash flows for each item/category of asset/liability.
II Identify variables such as principal amount, maturity date, and coupon rate.
III Determine the Modified Duration Gap.
IV Calculate the Modified Duration of each category of asset/liability.
V Determine the yield curve to arrive at the yields based on current market yields.

(A) (II), (I), (V), (IV), (III)
(B) (I), (II), (IV), (V), (III)
(C) (V), (I), (II), (IV), (III)
(D) (II), (V), (I), (IV), (III)

Oct/Nov 2012

45. Consider the following statements regarding the formulation of stress scenarios based on a bank's IRR profile:

I Scenarios should include instantaneous and significant rate changes.
II Scenarios should account for changes in the relationships between key market rates (basis risk).
III In low-rate environments, scenarios involving significant declines in market rates should be prioritized over rising-rate scenarios.

Which combination of the statements is correct?

(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

May/June 2015

46. Which of the following is identified as a strength of the static Traditional GAP analysis?

(A) It accurately incorporates the time value of money for future cash flows.

(B) It identifies specific balance sheet risks and is easy to understand.
(C) It captures the risk associated with options in loans and deposits.
(D) It incorporates dynamic growth and expected changes in the asset mix.

Oct/Nov 2013

47. What is the most appropriate caveat identified when a bank actively attempts to vary its GAP or DGAP to consistently win in the market?
(A) Derivatives trading always results in regulatory penalties if used to alter the GAP position.
(B) Interest rate forecasts are frequently wrong, and management must predict future rates better than consensus forecasts.
(C) A zero GAP is a mandatory regulatory requirement, thus active variation is heavily penalized by capital charges.
(D) Altering GAP guarantees near-term profitability but always triggers long-term insolvency.

May/June 2008

48. A 10-year bond has a computed Macaulay Duration of 7.5 years. If the current half-yearly yield to maturity on the bond is 4% (annual yield of 8%), what is the Modified Duration of the bond?
(A) 6.94 years
(B) 7.21 years
(C) 7.78 years
(D) 6.45 years

Oct/Nov 2017

49. A bank has an MDA of 3.20, MDL of 2.10, RSA of ₹8,000 crores, and RSL of ₹6,000 crores. The bank management decides to immunize the balance sheet by adjusting the duration of the assets. To set the MDG exactly to zero, what must be the new target MDA?
(A) 1.575
(B) 1.10
(C) 2.80
(D) 4.26

May/June 2006

50. Using the formula $\Delta E = -[MDG] \times RSA \times \Delta i$, calculate the change in Economic Value of Equity (EVE) given an MDG of 1.20, RSA of ₹15,000 crores, and an instantaneous parallel interest rate increase of 200 basis points (2%).
(A) Increase of ₹360 crores
(B) Increase of ₹180 crores
(C) Decrease of ₹360 crores
(D) Decrease of ₹180 crores

Oct/Nov 2008

51. Consider the following statements concerning Variance Analysis within Back Testing:
I Variance analysis helps assure management that the IRR measurement system is providing meaningful information.
II Management should document their analysis, highlighting any material variances and identifying their primary causes.
III Variances cannot be identified by comparing key financial indicators like cost of funds; they must be identified exclusively through gross ledger audits.
Which combination of the statements is correct?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

May/June 2024

52. Consider the following statements concerning Economic Value of Equity (EVE) analysis:
I EVE analysis is essentially a liquidation analysis utilizing market value accounting.
II The value of EVE is the residual figure equal to the difference between the market value of assets and the market value of liabilities.
Which of the following is correct?
(A) Statement (I) is true and Statement (II) is false.
(B) Statement (I) is false and Statement (II) is true.
(C) Both Statement (I) and Statement (II) are true.
(D) Both Statement (I) and Statement (II) are false.

Oct/Nov 2021

53. A bank holds a portfolio consisting of two bonds. Bond X has a market value of ₹600 crores and a Modified Duration of 3.0. Bond Y has a market value of ₹400 crores and a

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Modified Duration of 5.5. What is the overall Modified Duration of the portfolio?
(A) 4.25
(B) 3.80
(C) 4.00
(D) 4.50

May/June 2013

54. Which of the following is not a strategy to reduce Interest Rate Risk when the Duration Gap (DGAP) is positive?
(A) Buying short-term securities and selling long-term securities.
(B) Making floating-rate loans and selling fixed-rate loans.
(C) Using short-term purchased liability funding from central bank funding facilities.
(D) Obtaining more core transactions accounts from stable sources.

Oct/Nov 2015

55. Match the DGAP Summary profiles in List-I with their impact on Equity in List-II when there is a change in the interest rate.
List I: DGAP Summary profile
P. Positive MDG, Interest rate increases
Q. Negative MDG, Interest rate decreases
R. Negative MDG, Interest rate increases
S. Zero MDG, Interest rate decreases
List II: Impact on Equity
1. Equity Increases
2. Equity Decreases
3. Equity remains unchanged (None)
4. Equity Decreases
(A) P-2, Q-4, R-1, S-3
(B) P-1, Q-2, R-3, S-4
(C) P-4, Q-3, R-2, S-1
(D) P-2, Q-1, R-4, S-3

May/June 2020

56. Match the management objectives in List-I with their corresponding strategic approaches in List-II.
List I: Management objective
P. Reduce asset sensitivity
Q. Increase asset sensitivity
R. Reduce liability sensitivity
S. Increase liability sensitivity
List II: Strategic approach
1. Buy short-term securities and shorten loan maturities
2. Issue long-term subordinated debt and put caps on deposit rates
3. Borrow more via noncore purchased liabilities
4. Move from floating-rate loans to term loans and put floors on loan rates
(A) P-4, Q-1, R-2, S-3
(B) P-1, Q-4, R-3, S-2
(C) P-4, Q-2, R-1, S-3
(D) P-2, Q-3, R-4, S-1

Oct/Nov 2005

57. Which of the following statements regarding Stress Testing in IRR management is incorrectly stated?
(A) It evaluates a bank's financial position under a severe but plausible scenario to assist in decision making.
(B) It is composed solely of sensitivity analysis, completely excluding scenario analysis to avoid model redundancy.
(C) Static interest rate shocks consisting of parallel shifts of only plus and minus 200 basis points are often not sufficient to adequately assess IRR exposure.
(D) Depending on a bank's IRR profile, stress scenarios should include changes in the shape or slope of the yield curve.

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May/June 2017

58. An investment portfolio contains a security with a Modified Duration of 5.2. If the yield on the security increases by 50 basis points (0.50%), what is the expected percentage change in the price of the security?
(A) Decrease of 2.6%
(B) Increase of 2.6%
(C) Increase of 5.2%
(D) Decrease of 5.2%

Oct/Nov 2024

59. Using the same initial profile (MDA = 3.20, RSA = ₹8,000 crores, RSL = ₹6,000 crores), if the bank chooses instead to immunize the balance sheet by increasing the duration of the liabilities, what must be the new target MDL to achieve an MDG of zero?
(A) 2.40
(B) 1.575
(C) 4.267
(D) 3.20

May/June 2010

60. A bank reports Rate Sensitive Assets (RSA) of ₹10,000 crores with an MDA of 2.50. The bank's Rate Sensitive Liabilities (RSL) stand at ₹9,000 crores with an MDL of 1.80. What is the calculated Modified Duration Gap (MDG) for the bank?
(A) 0.70
(B) 0.88
(C) 1.05
(D) 1.62

Oct/Nov 2011

61. Which of the following defines "Optionality risk" in the context of banking?
(A) Potential loss arising from an inability to meet short-term funding obligations due to a severe market liquidity squeeze.
(B) Risk arising from imperfect correlation in the adjustment of rates earned and paid on different banking instruments.
(C) Risk from adverse price movements in instruments that respond automatically or behaviorally to interest rate changes.
(D) Risk that the entire principal of a long-term fixed-income bond will default upon its final maturity or coupon date.

May/June 2009

62. A bank holds a significant portfolio of fixed-rate commercial loans, rendering the institution highly asset sensitive with a prolonged asset duration. In a rising interest rate environment, which of the following derivative transactions would most effectively reduce the asset/liability mismatch and improve profitability?
(A) Entering an interest rate swap where the bank pays a fixed rate and receives a floating rate.
(B) Entering an interest rate swap where the bank pays a floating rate and receives a fixed rate.
(C) Writing an unhedged put option on long-term government securities to increase premium income.
(D) Purchasing long-term fixed-rate government bonds to increase the duration of the asset portfolio.

Oct/Nov 2019

63. Consider the following statements regarding the policies for Interest Rate Risk Mitigation:
I Permissible strategies and types of derivative contracts must be defined.
II Authority levels and titles of individuals approved to initiate hedging transactions must be documented.
III Monitoring requirements must ensure hedging activities fall within approved limits.
IV Controls must be in place to ensure compliance with technical accounting guidance covering hedging activities.
V Hedging strategies are deemed suitable for all institutions, regardless of their technical expertise.
Which combination of the above statements is correct?
(A) (I), (II), (III), and (V) only
(B) (I), (II), (IV), and (V) only
(C) (I), (II), (III), and (IV) only
(D) (I), (II), (III), (IV), and (V)

May/June 2025

64. Which of the following statements correctly describes the economic value perspective of assessing interest rate risk?
(A) It strictly measures the impact of short-term variations on the reported accrual earnings for the current financial year.
(B) It minimizes the economic value of risk solely by matching the repricing of assets with liabilities beyond the short term without considering earnings volatility.
(C) It reflects the sensitivity of the net worth of the bank to fluctuations in interest rates by evaluating the present value of expected net cash flows.
(D) It ignores the off-balance sheet items and focuses completely on the static book value of trading book investments.

Oct/Nov 2007

65. A bank is highly liability sensitive due to an extensive portfolio of short-term time deposits funding long-term 30-year fixed-rate mortgages. Anticipating a sharp increase in interest rates, management needs to deploy an on-balance sheet strategy rapidly. Which of the following actions is most suitable?
(A) Increasing the origination and retention of new 30-year fixed-rate mortgages at current market rates.

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(B) Securitizing and selling long-term mortgage products to reduce the volume of current holdings.
(C) Issuing shorter-term certificates of deposit to attract more immediate funds from the retail sector.
(D) Purchasing additional long-term government bonds to bolster the asset base and improve liquidity ratios.

May/June 2014

66. Match the typical hedging strategies in List-I with their corresponding definitions in List-II.
List I: Hedging strategy
P. Altering the balance sheet
Q. Cash flow matching
R. Duration matching
S. Derivative instruments
List II: Definition
1. Matching the terms of funding and assets so repricing occurs simultaneously, stabilizing net cash flow.
2. Modifying exposures by increasing or decreasing physical loan or deposit levels (e.g., selling fixed-rate mortgages).
3. Utilizing swaps, forwards, or options to limit specific exposures without changing the physical balance sheet.
4. Matching the effective price sensitivities of asset and liability pools to limit net changes in fair values.

(A) P-2, Q-1, R-4, S-3
(B) P-1, Q-2, R-3, S-4
(C) P-4, Q-3, R-2, S-1
(D) P-2, Q-4, R-1, S-3

Oct/Nov 2016

67. A bank calculates its initial NII as ₹80 crores derived from ₹1000 crores of RSA yielding 8% and ₹1000 crores of RSL costing 0%. The bank subsequently faces a severe economic shock where rates rise, shifting the RSA yield to 10% and the RSL cost to 4%. Assume volumes remain unchanged. What is the newly calculated NII and the percentage change from the initial NII?
(A) NII is ₹100 crores; an increase of 25%
(B) NII is ₹40 crores; a decrease of 50%
(C) NII is ₹120 crores; an increase of 50%
(D) NII is ₹60 crores; a decrease of 25%

May/June 2018

68. Identify the incorrect pair regarding the key definitions related to Asset Liability Management.
(A) Refinancing Risk - Arises when a bank holds shorter-term assets compared to longer-term liabilities.
(B) Economic Value Perspective - Focuses on the present value and timing of expected future cash flows and their impact on underlying value.
(C) Reinvestment Risk - Arises when a bank holds shorter-term assets compared to longer-term liabilities.
(D) Optionality Risk - Arises from adverse price movements in instruments that respond automatically or behaviorally to interest rate changes.

Oct/Nov 2022

69. The following question consists of two statements, an Assertion (A) and a Reason (R).
Assertion (A): To mitigate interest rate risk, a bank may enter into a swap contract to exchange a stream of floating-rate deposit payments for a fixed-rate payment stream.
Reason (R): This specific swap transaction effectively shortens the duration of the floating-rate deposits, aligning them with short-term assets in a falling-rate environment.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2005

70. Which of the following statements is incorrect regarding the management of Net Interest Income (NII) and GAP?
(A) If a bank has a zero GAP, changes in interest rates do not alter NII because changes in interest income equal changes in interest expense.
(B) A bank can systematically increase NII if it accurately forecasts rates to increase by

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becoming more liability sensitive.

(C) The size of the effective GAP signifies how much risk a bank is taking; the larger the absolute value of the GAP, the greater the potential variation in NII.

(D) It is virtually impossible for a bank to maintain a zero GAP continuously given the complexity and dynamism of balance sheet inflows and outflows.

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ANSWERS

1. (D) The earnings perspective focuses on near-term reported interest income, whereas the economic value perspective evaluates the present value of all cash flows.
The earnings perspective evaluates the short-term impact of interest rate changes on reported net interest income over a specific horizon. Conversely, the economic value perspective offers a long-term view by calculating the present value of all expected cash flows. This approach measures the sensitivity of the bank's net worth to interest rate fluctuations across all maturity timeframes.

2. (C) $NIM = \frac{\text{Net Interest Income}}{\text{Total Earning Assets}} \times 100$
Net Interest Margin serves as a critical indicator of a bank's profitability from its core lending and investment activities. It is calculated by taking the net interest income and dividing it by the total volume of interest-earning assets. This percentage reflects how effectively the institution generates income relative to the assets that are subject to interest rate movements.

3. (C) Top-level involvement, Structure and responsibilities.
The Asset Liability Management organization pillar establishes the governance framework necessary for managing financial risks effectively. This involves the commitment and involvement of top-level management to provide strategic guidance. Furthermore, it defines the specific roles, structure, and responsibilities of committees like the ALCO to ensure that risk management processes are properly integrated into the bank's daily operations.

4. (C) Changes in the historical cost and annual depreciation of physical fixed assets.
Net interest income is primarily influenced by factors that directly impact interest-bearing accounts on the balance sheet. These include shifts in market interest rates, changes in the total volume of funds, and the specific composition of assets and liabilities. Non-interest expenses, such as the depreciation of physical fixed assets and historical cost accounting, do not directly affect interest-related earnings or expenses.

5. (B) It is exclusively concerned with the imperfect correlation in the adjustment of rates earned and paid on completely different benchmark indices.
Yield curve risk occurs when the relationship between interest rates of different maturities changes, affecting the slope and shape of the curve. This risk manifests when the curve flattens, steepens, or inverts, impacting the economic value of mismatched positions. Basis risk, however, specifically refers to imperfect correlation between different benchmark indices used for pricing assets and liabilities throughout the bank.

6. (B) Over 4 years and up to 5 years
Regulatory frameworks prescribe specific time intervals for categorizing rate-sensitive items to measure repricing mismatches accurately. Standard buckets usually include short-term periods like one to twenty-eight days and long-term periods exceeding ten years. The interval covering four to five years is not typically listed as a distinct, mandatory time bucket under the standard guidelines provided for traditional gap analysis.

7. (B) The strategic management of a bank's assets and liabilities to achieve financial objectives and risk tolerance.
Asset Liability Management is defined as the strategic coordination of a bank's balance sheet components to meet financial targets while controlling risk. This process involves managing the interplay between assets and liabilities to mitigate interest rate and liquidity exposures. It ensures the bank operates within established risk tolerance levels while pursuing long-term sustainability and stability.

8. (B) (I), (III), and (IV) only
Optionality risk arises from features in financial contracts that give customers the right to alter

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cash flows. Holders of options enjoy limited risk while maintaining high reward potential. Examples include loans with prepayment rights and deposits that can be withdrawn at any time. Banks writing these options face significant risks because they must honor these customer-initiated changes in interest-rate environments.

9. (B) Increase of ₹4.50 crores
To determine the impact on interest income, calculate the gap by subtracting liabilities from assets. The resulting negative gap of three hundred crores indicates that the bank is liability sensitive. When market interest rates decrease by one point five percent, the reduction in interest expense exceeds the reduction in interest income, leading to a net increase of four point five crores.

10. (B) (I) and (III) only
Interest rate risk policies provide the foundational framework for managing rate-related exposures in accordance with the board's strategic risk appetite. These policies define essential reporting structures for senior management and the board to ensure transparency and oversight. Comprehensive policies must include measurement frequencies and valuation standards to ensure that all risk positions are accurately and regularly assessed.

11. (D) Decrease of ₹9.00 crores
A positive cumulative gap of twelve hundred crores signifies that the bank is asset sensitive. When market interest rates decrease by seventy-five basis points, the interest income earned on assets falls more than the interest paid on liabilities. Consequently, the bank's earnings decrease by nine crores, which is calculated by multiplying the gap amount by the interest rate change.

12. (C) To identify, manage, and control a bank's balance sheet risks and capital in execution of chosen business strategies.
The Asset-Liability Committee is the primary body responsible for managing the bank's balance sheet risks and capital. Its core objective is to ensure that financial strategies align with risk tolerance and business goals. ALCO identifies and controls various risks, including liquidity and interest rate exposures, to optimize the bank's overall financial performance and long-term institutional stability.

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13. (A) The full amount of the loan is shown as rate sensitive for the 0 to 30 days time interval.
Loans linked to the Marginal Cost of Funds Based Lending Rate are subject to periodic interest rate resets. If the rate resets monthly, the entire principal amount is considered rate sensitive within the first thirty days. This classification ensures that the gap analysis accurately reflects the timing of interest income changes following market shifts in the underlying benchmark rate.

14. (C) Inverted yield curve - Suggests yields will be lower at the longer end, often associated with recessionary conditions.
An inverted yield curve is a significant market indicator where long-term interest rates fall below short-term rates. This phenomenon often precedes economic recessions and reflects investor expectations of lower future inflation or declining growth. It is characterized by the downward slope of the curve, showing that long-term yields provide lower returns compared to instruments with shorter maturity dates.

15. (A) (III), (IV), (V), (I), (II)
Preparing a gap analysis involves a logical sequence starting with forecasting interest rates and defining time buckets. Assets and liabilities are then grouped into these buckets based on their repricing dates. Finally, the periodic and cumulative gaps are calculated to assess the resulting impact on net interest income under the projected interest rate scenario as defined by management.

16. (A) Imbalances between maturity/interest sensitivities of funding and loans, and between total funds collected and lent.
Asset liability transformation in financial intermediation typically creates two distinct types of imbalances. The first involves mismatches between the maturity or interest rate sensitivity of assets and the liabilities funding them. The second imbalance concerns the difference between the total volume of funds collected through deposits and the total amount of capital lent out as various bank loans.

17. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
A negative gap exists when rate-sensitive liabilities exceed rate-sensitive assets within a specific timeframe. If market interest rates rise, the cost of funding these liabilities increases faster than the income generated by the assets. This results in a squeeze on net interest income, confirming that the imbalance in repricing volume is the primary driver of the earnings decline.

18. (A) Quarterly, from March 2023
Domestic Systemically Important Banks must adhere to specific reporting standards regarding interest rate risk in the banking book. Regulatory guidelines require these institutions to submit returns on a quarterly basis. This reporting cycle commenced in March 2023, ensuring that regulators can monitor the risk profiles and capital adequacy of major financial institutions more frequently and with greater detail.

19. (B) Statement (I) is false and Statement (II) is true.
A positive gap indicates that a bank is asset sensitive because it has more assets than liabilities repricing. Conversely, a negative gap means the bank is liability sensitive, with more liabilities subject to rate changes. If interest rates rise, a liability-sensitive bank faces higher expenses than income, leading to a general decline in the institution's net interest income.

20. (A) Risk from imperfect correlation in the adjustment of rates earned and paid on instruments with similar repricing traits.
Basis risk arises when interest rates on various assets and liabilities do not move in perfect synchronization, despite having similar repricing characteristics. This exposure occurs when the interest rate indices used for pricing different instruments change by different amounts or at different times. It highlights the potential for volatility in net interest income due to imperfect correlation between benchmark rates.

21. (C) +₹250 crores
The cumulative gap is determined by adding the periodic gaps across sequential time intervals. For the first two buckets, the periodic gaps are negative one hundred fifty crores and positive four hundred crores. Adding these values together results in a cumulative gap of positive two hundred fifty crores, representing the total repricing mismatch up to the three-month time horizon.

22. (D) (I), (II), (III), (IV), and (V)
The Asset-Liability Committee plays a vital role in capital management by overseeing risk policies and optimizing risk-weighted assets. It reviews capital usage across business units to ensure alignment with the board's overarching strategy and targets. Furthermore, it approves capital allocation and monitors long-term trends to maintain adequate capital levels and ensure a healthy return on invested capital.

23. (D) Refinancing risk
Refinancing risk occurs when a bank funds long-term, fixed-rate assets with short-term, variable-rate liabilities. If interest rates rise when these short-term liabilities mature, the bank must replace them at a higher cost while the asset yield remains static. This imbalance leads to reduced profitability and highlights the risks associated with funding long-term commitments with short-term funding sources.

24. (D) NIM remains constant as both interest spread and proportionality are maintained.
Net Interest Margin is a relative measure expressing net interest income as a percentage of total earning assets. If a bank doubles both its assets and liabilities while keeping the interest rates and composition identical, the absolute net interest income doubles. However, because the asset base also doubles, the resulting ratio remains the same, leaving the margin unchanged for the bank.

25. (B) The deposit is classified as rate-sensitive in the 1-90 days time bucket because the interest rate is required to be reset at prescribed intervals.
Deposits linked to floating benchmarks like the Mumbai Interbank Offered Rate are classified based on their reset frequency rather than their final maturity. Because the interest rate resets every ninety days, the instrument is considered rate sensitive within the ninety-day time

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bucket. This approach ensures the gap analysis reflects the actual timing of cash flow changes driven by market rate movements.

26. (D) General Manager Audits & Inspection
The Asset-Liability Committee is composed of core members who hold primary decision-making authority over balance sheet risks. While senior executives and department heads for finance and credit are central to these discussions, other officials like the General Manager of Audits and Inspection typically attend in an advisory or observational capacity rather than as core decision-making members.

27. (A) P-2, Q-4, R-1, S-3
The impact on net interest income depends on whether the gap is positive or negative and the direction of interest rate movements. A positive gap leads to higher income when rates rise but lower income when rates fall. Conversely, a negative gap results in increased income during rate decreases and reduced income when interest rates increase across the market.

28. (A) The risk presented by assets and liabilities that reprice at different times and rates when maturity dates and/or repricing dates are not matched.
Repricing risk is the primary form of interest rate risk, arising from differences in the timing of rate changes for assets and liabilities. It occurs when instruments mature or reprice at different intervals, leaving the bank exposed to fluctuations in market rates. This mismatch can lead to significant variations in both earnings and the economic value of the institution.

29. (C) ₹15 crores
Net Interest Income is the difference between interest earned on assets and interest paid on liabilities. In this scenario, the bank earns eight percent on five hundred crores, totaling forty crores. It pays five percent on the same amount, totaling twenty-five crores. Subtracting the expense from the income yields an annual net interest income of fifteen crores for this transaction.

30. (D) Humped yield curve - Indicates short-term interest rates are expected to fall continuously without rising.
A humped yield curve indicates that interest rates for medium-term maturities are higher than those for both short-term and long-term maturities. This shape does not signal that rates will fall continuously. Instead, it often suggests a period of transition or uncertainty where investors expect rates to rise in the near term before eventually declining over a longer period.

31. (C) Frederick Macaulay
Frederick Macaulay introduced the concept of duration in 1938 to provide a more accurate measure of a fixed-income instrument's effective maturity. Unlike simple maturity, duration considers the timing and size of all future cash flows. It serves as a vital tool for assessing price sensitivity to interest rate changes in bond portfolios and overall banking books.

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32. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
Duration analysis typically assumes that interest rates for all maturities change by the same amount, known as a parallel shift. However, in real market conditions, short-term and long-term rates often move independently, changing the yield curve's slope. While both statements are factually correct, the reality of non-parallel shifts is a limitation rather than an explanation of the initial assumption.

33. (B) (I), (III), and (IV) only
Traditional gap analysis has several limitations, including its reliance on book value accounting and its failure to consider the time value of money. It also struggles to accurately account for behavioral options, such as early deposit withdrawals. Furthermore, the use of arbitrary time buckets can lead to inaccuracies in capturing the exact timing of cash flows within those ranges.

34. (C) Both Statement (I) and Statement (II) are true.
Measurement system reports are essential tools that quantify the impact of interest rate scenarios on earnings and economic value.

They provide the data necessary for informed decision-making by senior management and the board. Formalized procedures for reviewing these results ensure that the bank's risk exposure is monitored consistently and reported through the appropriate governance channels.

35. (A) (I), (II), (III), and (V) only
The modified duration gap framework measures the sensitivity of a bank's net worth to interest rate changes by comparing the weighted durations of assets and liabilities. It accounts for the duration of rate-sensitive items but must also include a leverage adjustment based on the liability-to-asset ratio. A larger gap signifies a higher exposure to potential interest rate shocks.

36. (A) Back Testing execution - Identifying material differences between actual and forecasted income and balance sheet amounts.
Back testing is a critical validation process that compares actual financial outcomes against the results predicted by risk models. It focuses on identifying material variances between forecasted and real income or balance sheet figures. This analysis helps management assess the accuracy of their interest rate risk measurement systems and identify necessary adjustments to improve future forecasting and risk management.

37. (A) It is the GAP divided by Earning Assets or Total Assets; the greater the ratio, the greater the interest rate risk.
The gap ratio provides a standardized measure of interest rate risk by dividing the gap amount by total earning assets or total assets. A higher ratio indicates that a larger portion of the balance sheet is exposed to repricing risk. This tool allows management to compare risk levels across different time periods or against common industry benchmarks.

38. (D) A decrease in interest rates will increase the Economic Value of Equity (EVE).
A positive modified duration gap indicates that the weighted average duration of assets is longer than the adjusted duration of liabilities. In this state, the market value of assets is more sensitive to interest rate changes than liabilities. Therefore, a decrease in interest rates will cause the value of assets to rise more than liabilities, increasing equity value.

39. (A) P-4, Q-1, R-2, S-3
Strategic balance sheet actions can mitigate interest rate risk by adjusting asset and liability durations. If the duration gap is positive, the bank can shorten assets by making floating-rate loans or lengthen liabilities by issuing long-term certificates of deposit. Conversely, if the gap is negative, lengthening assets through fixed-rate loans or shortening liabilities helps reduce the overall risk exposure.

40. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Modified duration serves as a direct measure of a bond's price sensitivity to interest rate changes. Bonds with identical modified durations will experience the same percentage change in price for a specific parallel shift in the yield curve. This relationship allows investors and risk managers to compare the price volatility of different fixed-income securities regardless of their coupon rates.

41. (A) (I), (II), and (III) only
Policies for managing interest rate risk with derivatives must be comprehensive, covering market, liquidity, and credit risks. They should clearly define the qualifications of staff managing these strategies and establish strict risk limits, including counterparty guidelines and position limits. Such controls ensure that hedging activities are performed by competent personnel and remain within the bank's established risk appetite.

42. (C) Traditional GAP emphasizes short-term earnings sensitivity, while DGAP focuses on price sensitivity and the present value of cash flows.
Traditional gap analysis focuses on short-term earnings sensitivity by measuring the mismatch in repricing volumes over specific intervals. In contrast, duration gap analysis evaluates the long-term impact on the bank's net worth by considering the price sensitivity of all cash flows. Duration gap accounts for the present value of future cash flows, providing a more comprehensive economic perspective.

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43. (B) It inherently captures the exact slope changes and convexity effects of the yield curve during major interest rate cycles.
While duration analysis is a powerful risk management tool, it possesses inherent weaknesses, such as the assumption of parallel yield curve shifts. It typically does not capture complex slope changes or convexity effects accurately. Furthermore, the model depends on subjective assumptions regarding repricing schedules and the behavioral characteristics of instruments with embedded customer options throughout the banking book.

44. (A) (II), (I), (V), (IV), (III)
Computing the change in economic value involves identifying key instrument variables and generating bucket-wise cash flows for assets and liabilities. Current market yields are then determined to establish the yield curve. Using this data, the modified duration for each category is calculated, ultimately allowing for the determination of the overall modified duration gap for the entire institution.

45. (A) (I) and (II) only
Stress testing scenarios should incorporate instantaneous and significant changes in interest rates to evaluate extreme market conditions. These tests must also account for basis risk by considering changes in the relationships between different market rates. Scenarios should be diverse, including both rising and falling rate environments, regardless of the bank's current interest rate levels or historical trends.

46. (B) It identifies specific balance sheet risks and is easy to understand.
Static traditional gap analysis is valued for its simplicity and its ability to clearly identify specific repricing risks on the balance sheet. It provides a straightforward framework that is easy for management and stakeholders to understand. By highlighting mismatches in various time buckets, it serves as an effective tool for initial risk assessment and future strategy development.

47. (B) Interest rate forecasts are frequently wrong, and management must predict future rates better than consensus forecasts.
Actively managing the gap to profit from interest rate movements is inherently risky because it relies on the accuracy of rate forecasts. Interest rate predictions are frequently incorrect, and for a bank to consistently succeed, its management must forecast future market conditions better than the consensus. Failure to do so can lead to significant financial losses for the institution.

48. (B) 7.21 years
Modified duration is calculated by dividing the Macaulay duration by one plus the yield per period. For a bond with a Macaulay duration of seven point five years and a semi-annual yield of four percent, the calculation is seven point five divided by one point zero four. This yields a modified duration of approximately seven point twenty-one years.

49. (A) 1.575
To achieve a zero modified duration gap, the weighted duration of assets must equal the duration of liabilities adjusted for the liability-to-asset ratio. Using the provided values, the calculation involves multiplying the liability duration of two point one zero by the ratio of six thousand to eight thousand. This results in a required target asset duration of one point five seven five.

50. (C) Decrease of ₹360 crores
The change in economic value is calculated by multiplying the positive modified duration gap, the total rate-sensitive assets, and the change in interest rates. For a gap of one point two zero, assets of fifteen thousand crores, and a two percent rate increase, the formula results in a decrease of three hundred sixty crores in the economic value of equity.

51. (A) (I) and (II) only
Variance analysis is a key component of back testing that ensures interest rate risk measurement systems remain accurate and reliable. Management must document and analyze significant differences between actual results and model forecasts to identify their root causes. This process allows the institution to refine its models and provides assurance

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that the risk information provided is truly meaningful for management.

52. (C) Both Statement (I) and Statement (II) are true.
Economic value of equity analysis adopts a long-term perspective by measuring the net worth of a bank based on market values. It treats the institution as a going concern, calculating the difference between the present value of assets and the present value of liabilities. This approach provides a comprehensive view of how interest rate changes affect the bank's underlying value.

53. (C) 4.00
The overall modified duration of a portfolio is the weighted average of the durations of the individual securities. In this case, Bond X represents sixty percent of the portfolio value and Bond Y represents forty percent. Multiplying their respective durations by these weights and summing the results gives a total portfolio modified duration of four point zero zero.

54. (C) Using short-term purchased liability funding from central bank funding facilities.
When the duration gap is positive, the bank is asset sensitive and vulnerable to rising rates. To reduce this risk, the bank should shorten asset durations or lengthen liability durations. Using short-term purchased liability funding actually shortens the duration of liabilities, which would increase a positive duration gap and exacerbate the institution's exposure to interest rate fluctuations.

55. (A) P-2, Q-4, R-1, S-3
Equity value changes depend on the sign of the modified duration gap and the direction of interest rate movements. A positive gap leads to lower equity when rates rise, while a negative gap causes equity to decrease when rates fall. If the gap is zero, the bank is immunized, and interest rate changes have no impact on equity value.

56. (A) P-4, Q-1, R-2, S-3
Managing sensitivity involves strategic changes to the repricing characteristics of assets and liabilities. To reduce asset sensitivity, a bank can shift toward longer-term fixed-rate loans. Conversely, to increase liability sensitivity, borrowing through short-term noncore liabilities is effective. These actions align the timing of interest rate adjustments with the bank's desired risk profile and strategic earnings objectives.

57. (B) It is composed solely of sensitivity analysis, completely excluding scenario analysis to avoid model redundancy.
Stress testing is a vital risk management tool that uses both sensitivity and scenario analysis to evaluate the bank's resilience to extreme market conditions. It should not be limited to simple interest rate shocks. Effective stress testing must include scenarios that reflect changes in the yield curve's shape and slope to capture the full range of potential financial risks.

58. (A) Decrease of 2.6%
The percentage change in the price of a security is calculated by multiplying its modified duration by the change in yield, with the sign reversed. For a security with a duration of five point two and a fifty-basis point increase in yield, the expected price change is a decrease of two point six percent, reflecting the inverse relationship between price and yield.

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59. (C) 4.267
To immunize the balance sheet by adjusting liabilities, the target modified duration of liabilities must be the asset duration divided by the liability-to-asset ratio. With an asset duration of three point two zero and a ratio of six thousand to eight thousand, the calculation results in a required target liability duration of four point two six seven to achieve a zero gap.

60. (B) 0.88
The modified duration gap is calculated by subtracting the product of the liability duration and the liability-to-asset ratio from the asset duration. Using ten thousand crores in assets and nine thousand crores in liabilities, the ratio is zero point nine. Subtracting one point six two from the asset duration of two point five zero results in a gap of zero point eighty-eight.

61. (C) Risk from adverse price movements in instruments that respond automatically or behaviorally to interest rate changes.
Optionality risk is the threat to earnings or capital arising from the exercise of options embedded in bank products. These options allow customers to alter the timing or amount of cash flows in response to interest rate changes. Common examples include the prepayment of loans or the early withdrawal of deposits, which can adversely affect the bank's long-term profitability.

62. (A) Entering an interest rate swap where the bank pays a fixed rate and receives a floating rate.
An asset-sensitive bank with long-duration fixed-rate loans faces risks if interest rates rise. To mitigate this, the bank can enter a swap where it pays a fixed rate and receives a floating rate. This effectively converts fixed-rate income into floating-rate income, shortening the asset duration and allowing interest income to increase in tandem with rising market rates.

63. (C) (I), (II), (III), and (IV) only
Risk mitigation policies for derivatives must define permissible strategies, authorized personnel, and monitoring requirements. They ensure all hedging activities align with the bank's risk limits and comply with technical accounting standards. Such policies are only suitable for institutions with the necessary expertise, as managing complex derivative instruments requires a deep understanding of market, liquidity, and various operational risks.

64. (C) It reflects the sensitivity of the net worth of the bank to fluctuations in interest rates by evaluating the present value of expected net cash flows.
The economic value perspective focuses on the impact of interest rate changes on the present value of all future cash flows. It provides a long-term view of risk by measuring the sensitivity of the bank's net worth. Unlike the earnings perspective, it accounts for the total market value of assets and liabilities, reflecting the underlying economic reality of the institution.

65. (B) Securitizing and selling long-term mortgage products to reduce the volume of current holdings.
A liability-sensitive bank with long-term fixed-rate mortgages is exposed to rising interest rates. To quickly reduce this risk, management can securitize and sell these long-term loans. This action removes long-duration assets from the balance sheet, reducing the mismatch with short-term liabilities. It also provides liquidity and allows the bank to reinvest in assets with shorter repricing intervals.

66. (A) P-2, Q-1, R-4, S-3
Banks employ various hedging strategies to manage interest rate risk, including altering the physical balance sheet or using derivatives. Cash flow matching involves aligning the timing of funding and assets to stabilize net income. Duration matching focuses on equalizing price sensitivities to protect equity value. These tools allow management to tailor their risk profile according to strategic goals and market conditions.

67. (D) NII is ₹60 crores; a decrease of 25%
Initial net interest income is eighty crores, based on an eight percent yield on one thousand crores. When rates rise, interest income becomes one hundred crores while interest expense increases to forty crores. The new net interest income is sixty crores. This represents a twenty-five percent decrease from the original amount, highlighting the impact of rising funding costs.

68. (A) Refinancing Risk - Arises when a bank holds shorter-term assets compared to longer-term liabilities.
Refinancing risk and reinvestment risk represent different sides of interest rate exposure. Refinancing risk occurs when short-term liabilities fund long-term assets. In contrast, reinvestment risk arises when a bank holds shorter-term assets compared to longer-term liabilities. In this case, the bank faces the risk that income from maturing assets will be reinvested at lower rates while funding costs remain static.

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69. (C) Assertion (A) is true, but Reason (R) is false.

Banks use interest rate swaps to manage duration and cash flow risks. By exchanging floating-rate payments for fixed-rate payments, a bank can lock in funding costs and lengthen the duration of its liabilities. This strategy is effective for mitigating risks in rising-rate environments. However, the logic that this specific transaction shortens duration for a falling-rate environment is factually incorrect.

70. (B) A bank can systematically increase NII if it accurately forecasts rates to increase by becoming more liability sensitive.

While a zero gap minimizes interest rate risk, it is difficult to maintain due to the dynamic nature of banking. A bank can increase net interest income by accurately forecasting rate changes. However, becoming liability sensitive when rates are expected to increase is the wrong strategy, as it would cause interest expenses to rise faster than interest income.

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CHAPTER 05
Liquidity Risk Management

Oct/Nov 2022

1. According to standard banking guidelines, where banks are not in a position to estimate the behavioural pattern of Savings Bank deposits, what notional percentage is treated as the volatile portion?
(A) 5%
(B) 10%
(C) 15%
(D) 20%

May/June 2014

2. Which statement regarding Intraday Liquidity Management is incorrect?
(A) Banks should actively monitor significant intraday settlement and clearing activity.
(B) Banks should maintain sufficient cash balances and daylight overdraft capacity when necessary.
(C) Intraday liquidity monitoring is only relevant for banks engaged exclusively in retail banking without payment and settlement activities.
(D) Banks must ensure the adequacy of collateral pledged to the central bank account to cover expected and unexpected intraday funding needs.

Oct/Nov 2007

3. What does the "Call Risk" element of liquidity refer to?
(A) The uncertainty of roll over or renewal of term deposits by holders on maturity dates.
(B) The idiosyncratic behavior of corporate and institutional depositors withdrawing funds without notice.
(C) The sudden requirement of funds to pay third parties when contingent liabilities devolve on the bank.
(D) The time gap between receipt of expected funds and the demand for funds to honor standing commitments.

May/June 2010

4. What is the most appropriate reason why the ALM Support Group prepares forecasts and simulations?
(A) To establish executive-level lines of authority for managing the bank's liquidity risk.
(B) To finalize the transfer pricing policy of the bank and integrate it with strategic planning.
(C) To show the effect of various possible changes in market conditions on the bank's liquidity position and recommend action to the ALCO.
(D) To dictate the business strategy of the bank to external regulatory authorities.

Oct/Nov 2024

5. What is the primary purpose of constructing a Dynamic Liquidity Statement as opposed to a Structural Liquidity Statement?
(A) A structural statement focuses on 90-day projections, whereas a dynamic statement looks at long-term behavioural maturities over 1 to 3 years.
(B) It captures short-term liquidity on a dynamic basis by assessing projected business growth over a 90-day horizon.
(C) A dynamic statement is utilized strictly to monitor daily intraday settlements, while a structural statement assesses foreign currency funding risk.
(D) A dynamic liquidity statement is based purely on historical empirical studies, while the structural statement incorporates future expected cash flows.

May/June 2017

6. What is the best approach for managing liquidity risks relating to off-balance sheet exposures like Special Purpose Vehicles (SPVs)?
(A) Classifying all such exposures as fixed assets and excluding them from the

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structural liquidity statement.
(B) Estimating and monitoring cash flows from contingent liabilities in normal and stressed market environments.
(C) Offsetting them automatically against intangible assets to neutralize the balance sheet effect.
(D) Ignoring past trends of macroeconomic stresses as they hold no predictive value for derivative cash flows.

Oct/Nov 2005

7. What is liquidity risk as defined in the context of banking?
(A) The risk that a bank cannot easily offset a position at the prevailing market price due to limited market depth.
(B) The risk of a bank's inability to meet cash and collateral obligations without incurring disproportionate cost.
(C) The risk of a bank failing to meet its required capital adequacy ratios under a stressed economic environment.
(D) The risk that depositors withdraw funds prematurely causing a breach in the statutory liquidity ratio.

May/June 2020

8. Regarding the behavioral study of assets and liabilities, which statement is true?
(A) Current deposits are entirely placed in the Day 1 bucket as they are payable on demand.
(B) The core portion of savings and current deposits may be placed in the over 1-3 years bucket.
(C) Behavioral studies for term deposits focus on assessing the seasonality in demand for funds.
(D) Residual maturities of term loans are immune to uncertainties as they have fixed repayment schedules.

Oct/Nov 2015

9. Which of the following is NOT listed as an objective of the Contingency Funding Plan (CFP)?
(A) Identify a menu of contingent liquidity sources under increasing adverse conditions.
(B) Maximize short-term profitability by liquidating long-term assets at a premium during crisis.
(C) Provide a plan for responding to various levels of a bank's liquidity stress.
(D) Designate management responsibilities, crisis communication methods, and reporting expectations.

May/June 2013

10. Which of the following best describes the fundamental difference between solvency and liquidity in a banking context?
(A) Solvency refers to having enough liquid assets to meet near-term obligations, while liquidity measures a bank's capacity to absorb unexpected losses through capital.
(B) Solvency depends exclusively on the market perception of the bank, whereas liquidity depends exclusively on the statutory reserves held with the central bank.
(C) Capital is the resource used to absorb unexpected losses to remain solvent, while liquidity ensures cash availability to meet obligations.
(D) A bank can never be solvent if it faces a liquidity crisis, as capital adequacy and sound liquidity management are synonymous.

Oct/Nov 2021

11. Arrange the following time buckets for monitoring cumulative negative mismatches in sequential order from shortest to longest duration:
1. 8-14 days
2. Next day
3. 15-30 days
4. 2-7 days

(A) 2, 4, 1, 3
(B) 2, 1, 4, 3
(C) 4, 2, 1, 3
(D) 2, 4, 3, 1

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May/June 2024

12. In which year did the Basel Committee on Banking Supervision (BCBS) publish the "Principles for Sound Liquidity Risk Management and Supervision"?
(A) 2006
(B) 2007
(C) 2008
(D) 2009

Oct/Nov 2008

13. Which of the following statements about the stock approach ratios is incorrect?

(A) The ratio of Temporary Assets to Volatile Liabilities with a value greater than 1 indicates a severe possibility of a liquidity problem.

(B) The ratio of Core deposits to Total Assets measures the extent to which assets are funded through a stable deposit base.

(C) The ratio of Temporary Assets to Total Assets measures the extent of available liquid assets.

(D) Volatile Liabilities include deposits, borrowings, and bills payable up to 1 year, as well as current and savings deposits.

May/June 2006

14. Which of the following accurately describes the idiosyncratic behavior of depositors as a factor contributing to liquidity risk?

(A) It arises when borrowers suddenly stop repayment installments on their loan obligations.

(B) It involves the unexpected devolution of contingent liabilities due to failure of counterparties under financial guarantees.

(C) It involves the sudden withdrawal of deposits by corporate and large institutional customers without prior notice.

(D) It refers to the uncertainty of renewal of matured term deposits matching historical trends.

Oct/Nov 2017

15. What is the most appropriate action for a well-managed bank to handle high-probability and low-impact liquidity risks?

(A) Rely exclusively on central bank emergency funding interventions.

(B) Trigger the escalation procedures of the Contingency Funding Plan.

(C) Immediately sell off all operating subsidiaries to augment the core deposit base.

(D) Incorporate planning for these risks into the day-to-day management of sources and uses of funds.

May/June 2008

16. How is "Market Liquidity Risk" formally defined?

(A) The risk that a bank cannot easily offset a position at market prices due to depth or market disruption.

(B) The risk that a bank will not be able to efficiently meet expected and unexpected current and future cash flows.

(C) The risk of sudden requirement of funds to make payments to third parties when contingent liabilities devolve.

(D) The risk arising from the sudden interruptions in inflow of funds due to stoppage of repayment installments.

Oct/Nov 2013

17. In the computation of the 'Temporary assets' metric for liquidity measurement, which component is NOT included?

(A) Net worth

(B) Balances with banks

(C) Investments up to one year

(D) Excess CRR balances with the central bank

May/June 2015

18. For banks whose Capital to Risk-weighted Assets Ratio (CRAR) is at least 25% more than the minimum required CRAR of 9%, up to what limit are they allowed to have a higher Inter-bank Liability (IBL) limit?

(A) 100% of the net worth

(B) 200% of the net worth

(C) 250% of the net worth

(D) 300% of the net worth

Oct/Nov 2012

19. Regarding the Stress Testing of liquidity risk, which statement is incorrect?

(A) The resilience of the bank to withstand the sudden change of market conditions is necessary.

(B) Stress testing forms an integral part of the overall governance and liquidity risk management culture.

(C) Stress testing evaluates the potential adverse impact of complex financial instruments and off-balance sheet items on the liquidity position.

(D) Banks should exclusively rely on historical data for stress scenarios while dismissing

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internal expert judgement.

May/June 2011

20. In the context of measuring liquidity risk using the flow approach, which of the following is correct?
(A) It forecasts liquidity at different points of time by tracking cash flow mismatches using a constructed maturity ladder.
(B) It involves calculating specific ratios like core deposits to total assets and comparing them to internal benchmarks.
(C) Cash inflows arise from liabilities falling due, while cash outflows arise from saleable non-maturing assets.
(D) The flow approach evaluates liquidity purely from a balance sheet angle at a static point without considering future time periods.

Oct/Nov 2020

21. Arrange the following steps in the computation of liquidity gap under the Flow Approach in the correct chronological sequence:
1. Construct the maturity ladder by placing assets and liabilities into time buckets.
2. Determine the deficit or surplus of funds in each individual time bucket and the cumulative deficit/surplus.
3. Set up norms for classification of assets and liabilities into different time buckets based on residual or effective maturity.

(A) 1, 2, 3
(B) 3, 1, 2
(C) 2, 3, 1
(D) 3, 2, 1

May/June 2022

22. The Dynamic Liquidity Statement of assets and liabilities is prepared to assess the net funding requirements over a chosen period, usually up to what time period?
(A) 14 days
(B) 30 days
(C) 90 days
(D) 180 days

Oct/Nov 2023

23. Why are retail deposits typically considered a more stable funding base compared to institutional deposits?
(A) Retail deposits are exclusively fixed-term deposits with stringent premature withdrawal penalties.
(B) Institutional depositors make decisions based purely on relationship factors rather than the rate of return.
(C) Institutional deposits are strictly monitored by regulators, making their sudden withdrawal legally impermissible under stressed situations.
(D) Retail deposits are driven by service and relationship factors, making them less sensitive to market interest rate changes.

May/June 2016

24. A bank seeks to diversify its alternative sources of funding through tactical actions. Which of the following is NOT a tactical action?
(A) Sale or pledging of liquid assets
(B) Accessing the inter-bank call market
(C) Drawing down committed facilities
(D) Issuance of debt instruments

Oct/Nov 2009

25. Which statement regarding the pledging of assets for liquidity is incorrect?
(A) Secured or collateralized borrowings are generally more reliable sources of liquidity and are lower cost compared to unsecured funding.
(B) The counterparty advance rates on various types of collateral have no influence on the amount and nature of collateral pledged.
(C) The credit quality, underwriting, or performance of pledged loans influences the nature of collateral.
(D) Regulatory actions against the bank can act as a factor influencing the pledging of assets.

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May/June 2023

26. Which of the following defines "Funding Liquidity Risk"?
(A) The risk that a bank cannot easily eliminate a position at the prevailing market price due to market disruption.
(B) The risk of loss arising from operational disturbances to payment and settlement systems.
(C) The inability to convert cash and cash-like assets quickly and at a reasonable cost.
(D) The inability to meet present and future funding needs without adversely affecting

operations or condition.

Oct/Nov 2018

27. Which option best describes the nature of "Time Risk or Tenor risk"?
(A) The time gap between receipt of expected funds and the demand for funds to honor standing commitments.
(B) The risk that institutional depositors unexpectedly exercise options to withdraw large funds without prior notice.
(C) The possibility of sudden requirements of funds to pay third parties upon the devolution of letters of credit.
(D) The risk of a bank being unable to roll over term deposits matching its historical trend of renewal.

May/June 2007

28. How do market liquidity risk and funding liquidity risk interact to create a downward liquidity spiral?
(A) Shocks to funding liquidity lead to asset sales, which depress asset prices and lower market liquidity, leading to higher margin calls and further increasing funding liquidity risk.
(B) Lower market liquidity directly reduces a bank's core deposits, which triggers idiosyncratic behavior of institutional depositors, leading to increased asset prices.
(C) A downward spiral occurs when a bank's surplus capital is locked in illiquid long-term assets, causing an artificial appreciation in asset prices and restricting wholesale funding.
(D) Funding liquidity risk eliminates the need for collateralized borrowing, forcing the bank to rely solely on retail deposits, which directly reduces market liquidity depth.

Oct/Nov 2025

29. Which of the following is NOT classified as a bank-specific factor that could affect a bank's liquidity risk?
(A) Deterioration in asset quality
(B) Down gradation of bank's credit rating
(C) Dislocations in national or global financial markets
(D) Breakdowns in internal systems or controls (fraud)

May/June 2012

30. What is an explicit responsibility of the Asset-Liability Management Committee (ALCO) with respect to liquidity risk?
(A) Enforcing management's duties to formulate the contingent funding plan exclusively for overseas affiliates.
(B) Conducting the internal audit of the adequacy of liquidity risk management processes independent of management.
(C) Deciding the transfer pricing policy solely on the basis of retail deposit volume without considering wholesale funding.
(D) Reviewing stress test scenarios and ensuring a well-documented Contingency Funding Plan is periodically reviewed.

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Oct/Nov 2014

31. Which of the following pairs accurately categorizes the action for funding strategy?
(A) Lengthening maturities of new liabilities — Tactical action
(B) Issuance of debt instruments — Tactical action
(C) Asset securitization — Strategic action
(D) Sale of liquid assets — Strategic action

May/June 2019

32. Read the following potential sources of funding and answer the question that follows.
I Drawing down committed facilities
II Retail deposit growth
III Sale of liquid assets
IV Raising capital
V Wholesale deposit growth
Which of the above are considered "tactical actions" during a severe liquidity shock?
(A) (I), (II), and (V)
(B) (I), (III), and (V)
(C) (II), (III), and (IV)
(D) (I), (IV), and (V)

Oct/Nov 2006

33. Match the organizational unit (List-I) with its responsibility (List-II):
List I: (Organizational Unit)
P. Board of Directors
Q. Risk Management Committee of Board
R. Asset-Liability Management Committee (ALCO)

S. ALM Support Group

List II: (Responsibility)

1. Evaluating overall risks faced by the bank including liquidity risk interactions
2. Formulating and deciding the strategy, policies, and procedures to manage liquidity risk
3. Preparing forecasts showing the effect of market conditions on liquidity
4. Deciding on desired maturity profile and mix of incremental assets and liabilities

(A) P-1, Q-2, R-3, S-4
(B) P-2, Q-1, R-4, S-3
(C) P-4, Q-3, R-2, S-1
(D) P-3, Q-4, R-1, S-2

May/June 2021

34. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.

Assertion (A): A bank should rely predominantly on a single source of wholesale funding to ensure continuous and uninterrupted liquidity.

Reason (R): Over-reliance on non-deposit funding sources can leave a bank vulnerable to unique business model shifts and systemic market disruptions.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2010

35. Read the following statements about asset securitization and answer the question that follows.

I It transforms off-balance-sheet items into marketable securities sold to depositors.
II Depending on the business model, securitization proceeds can serve as a material source for meeting ongoing and future funding needs.

Which of the above statement(s) is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2005

36. Read the following scenario regarding market-wide shocks and answer the question that follows.

An investment firm closed three vehicles heavily invested in subprime mortgages, causing the interbank market to freeze. A separate bank, though lacking direct exposure to those mortgages, could not secure funding due to the market freeze.

Which form of liquidity risk interaction is evident here?

(A) A market shock causing severe funding constraints on banks dependent on short-term markets.
(B) The idiosyncratic risk of retail depositors causing a market disruption in subprime loans.
(C) Operational risk translating directly into a decline in core capital adequacy and asset quality.
(D) Call risk materializing due to the devolution of derivative guarantees and letters of credit.

Oct/Nov 2022

37. Match the principles for sound liquidity risk management (List-I) with their respective focal areas (List-II):

List I: (BCBS Principles)

P. Principle 2
Q. Principle 4
R. Principle 11
S. Principle 12

List II: (Focal Areas)

1. Maintain a cushion of unencumbered, high quality liquid assets
2. Clearly articulate a liquidity risk tolerance appropriate for business strategy
3. Have a formal contingency funding plan (CFP)
4. Incorporate liquidity costs, benefits and risks in internal pricing

(A) P-2, Q-4, R-3, S-1

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(B) P-1, Q-3, R-4, S-2
(C) P-4, Q-2, R-1, S-3
(D) P-2, Q-1, R-3, S-4

May/June 2018

38. Read the following statements concerning tolerance levels for negative cumulative mismatches in a structural liquidity statement:

I The mismatch in the next day bucket should not exceed 5%.
II The mismatch in the 2-7 days bucket should not exceed 10%.
III The mismatch in the 8-14 days bucket should not exceed 15%.
IV The mismatch in the 15-30 days bucket should not exceed 20%.

Which of the above statement(s) is/are correct?

(A) Only (I), (II), and (IV)
(B) Only (II), (III), and (IV)
(C) Only (I), (III), and (IV)
(D) (I), (II), (III), and (IV)

Oct/Nov 2016

39. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.

Assertion (A): Banks are highly leveraged businesses wherein the inability to maintain adequate liquidity can cause a systemic liquidity crisis.

Reason (R): Depositors repose trust in the belief that they will get their funds back as and when they want; an undermining of this faith leads to withdrawal of money and migration of borrowers.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2014

40. Which of the following pairs regarding liquidity limits and regulations is incorrectly matched?

(A) Inter-bank Liability Limit (Standard) — 200% of net worth as of March 31 of previous year
(B) Higher IBL limit condition — CRAR at least 25% more than the regulatory minimum
(C) Call Money Lending Maximum Limit — 50% of capital funds on any day
(D) Call Money Borrowing Limit — Not to exceed 100% of capital funds on a fortnightly average.

Oct/Nov 2007

41. Read the following scenario regarding crisis communication and answer the question that follows.

A central bank was notified about a specific bank's funding problem, but the subsequent public announcement of emergency support led to a bank run.

What lesson does this highlight regarding the Contingency Funding Plan (CFP)?

(A) Crisis communication must be poorly managed to encourage transparency among stakeholders.
(B) Clear crisis communication is vital, as perception impacts depositor trust and liquidity strains.
(C) The CFP should ignore external communication entirely to avoid creating unnecessary market panic.
(D) Securitization of assets should be publicly halted immediately during any external communication.

May/June 2025

42. Match the external factors affecting liquidity (List-I) to their examples (List-II):

List I: (External Factors)
P. Geographical
Q. Systemic
R. Financial sector
S. Operational

List II: (Examples)
1. Major changes in national or global economic conditions
2. Disturbances to payment systems or local natural disasters
3. Financial scandal or failure of major firms affecting public confidence
4. Deteriorating local economic conditions

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(A) P-1, Q-2, R-3, S-4
(B) P-2, Q-3, R-4, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-3, Q-2, R-4, S-1

Oct/Nov 2019

43. Read the following statements about stress testing for liquidity and answer the question that follows.

I Stress tests should incorporate the major funding and market liquidity risks.
II The link between reductions in market liquidity and constraints on funding liquidity should be taken into account.
III Possible stress events include a prompt corrective action capital downgrade.
IV ALCO should thoroughly discuss the results of stress tests.

Which of the above statement(s) is/are correct?

(A) Only (I), (II), and (III)
(B) Only (I), (III), and (IV)
(C) Only (II), (III), and (IV)
(D) (I), (II), (III), and (IV)

May/June 2009

44. Read the following components of risk management and answer the question that follows.

I Intraday liquidity and collateral management
II Internal audit of the adequacy of liquidity risk management processes
III Comprehensive contingency funding plans

Which of the above are considered key components of a sound liquidity risk management process?

(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2011

45. Read the following scenario regarding deposit composition and answer the question that follows.

In a specific banking crisis, the institution's retail deposits consisted significantly of postal and telephone accounts rather than traditional branch-based deposits.

Why did this composition of retail deposits prove vulnerable?

(A) Non-branch retail deposits possess a historically inelastic behavior compared to branch deposits.
(B) These depositors generally claimed lower interest rates and had strict contractual lock-in periods.
(C) Weak customer-branch relationships reduced loyalty, making funds rate-sensitive and prone to flight.
(D) Postal accounts are subject to higher mandatory statutory reserves, which restricts the bank's lending.

May/June 2010

46. Match the specific forms of liquidity risks (List-I) to their triggers (List-II):

List I: (Liquidity Risk Forms)
P. Idiosyncratic behavior
Q. Funding Risk (Renewal)
R. Time Risk
S. Call Risk

List II: (Triggers)
1. Contingent liabilities devolving unexpectedly
2. Sudden withdrawal of deposits by large customers without notice
3. Renewal pattern of matured deposits deviating from historical trends
4. Gap between expected inflows and demand due to failure of contractual commitments

(A) P-3, Q-2, R-1, S-4
(B) P-2, Q-3, R-4, S-1
(C) P-4, Q-1, R-2, S-3
(D) P-2, Q-4, R-3, S-1

Oct/Nov 2024

47. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.

Assertion (A): Maintaining both capital adequacy and sound liquidity management is essential for a stable banking system.

Reason (R): Capital acts as a cushion to absorb unexpected losses to keep the bank solvent, while liquidity measures the assets available to meet near-term obligations.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

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(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2017

48. Which of the following combinations of metrics and their components is incorrectly paired?
(A) Temporary assets — Includes Swap funds (sell/buy) up to one year
(B) Earning Assets — Includes Intangible assets
(C) Core deposits — Includes All deposits above 1 year and net worth
(D) Volatile Liabilities — Includes Letters of credit full outstanding

Oct/Nov 2005

49. Read the following stress events and answer the question that follows.
I Deterioration in credit quality
II Decline in the bank's composite rating
III Positive press coverage
IV Public cybersecurity-related event
V Rising reputation risks
Which of the above are identified as situations causing a significant negative impact on a bank's liquidity?
(A) (I), (II), (III), and (IV)
(B) (I), (II), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

May/June 2020

50. Read the following statements regarding regulatory limits and answer the question that follows.
I The standard limit for Inter-bank Liability (IBL) of a bank should not exceed 200% of its net worth.
II The IBL limit includes collateralized borrowings and specific refinance facilities.
III Call money borrowing limit on a fortnightly average basis should not exceed 100% of the bank's capital funds.
Which of the above statement(s) is/are correct?
(A) Only (I) and (III) are correct
(B) Only (II) and (III) are correct
(C) Only (I) and (II) are correct
(D) (I), (II), and (III) are correct

Oct/Nov 2015

51. Read the following scenario regarding asset expansion and answer the question that follows.
A bank expanded its mortgage assets at a constant equivalent annual rate of 23.2%, far outstripping the growth of its traditional funding base.
In terms of structural balance sheet management, this expansion represents a failure in managing what?
(A) The netting of off-balance sheet exposures against core equity and Tier 2 capital reserves.
(B) The alignment of risk-taking incentives with daily intraday settlement monitoring requirements.
(C) The conversion of fixed assets into purely volatile liabilities through aggressive market borrowing.
(D) Long-term mortgage assets funded by short-term liabilities, creating severe funding mismatches.

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May/June 2013

52. Which of the following pairs of Stock Ratios and their corresponding Industry Average percentages is correctly matched?
(A) Core deposits to Total Assets — 80%
(B) Temporary Assets to Volatile Liabilities — 150%
(C) Volatile Liabilities to Total Assets — 40%
(D) Temporary Assets to Total Assets — 40%

Oct/Nov 2021

53. Read the following statements concerning deposit stability and answer the question that follows.
I A bank with high retail deposit generation can build a more diversified funding base that is highly sensitive to changes in market interest rates.
II Institutional deposits are typically obtained in bulk and may react more rapidly to a bank's deteriorating financial condition than retail depositors.
Which of the above statement(s) is/are correct?
(A) Only (I) is correct

(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2024

54. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.

Assertion (A): Market liquidity and funding liquidity are distinct risks that act completely independently of each other during a financial crisis.

Reason (R): Lower market liquidity leads to higher margin calls, which increases funding liquidity risk and establishes a downward liquidity spiral.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2008

55. An intraday liquidity strategy adopted by senior management should allow the bank to perform which of the following actions?

I Active monitoring of significant intraday settlement and clearing activity.
II Maintenance of sufficient cash balances and daylight overdraft capacity.
III Provisioning of adequate collateral pledged to the central bank account to cover unexpected intraday needs.
IV Banning all intraday trading activities to preserve systemic stability.

Which of the above statement(s) is/are correct?

(A) Only (I), (II), and (IV)
(B) Only (I), (II), and (III)
(C) Only (II), (III), and (IV)
(D) Only (I), (III), and (IV)

May/June 2006

56. Match the asset/liability item (List-I) to its behavioral study objective (List-II):

List I: (Asset/Liability Item)
P. Demand deposits
Q. Term deposits
R. Contingent liabilities
S. Overdrafts

List II: (Behavioral Study Objective)
1. Find core and volatile portions of sanctioned credit limits
2. Assess the average percentage of funds outflow due to invocation of guarantees
3. Find the core portion that remains with the bank and volatile portion that fluctuates
4. Establish average percentage of renewal and premature withdrawal

(A) P-3, Q-4, R-2, S-1
(B) P-4, Q-3, R-1, S-2
(C) P-2, Q-1, R-4, S-3
(D) P-1, Q-2, R-3, S-4

Oct/Nov 2017

57. Read the following scenario regarding a liquidity crisis and answer the question that follows.

A financial institution relied heavily on covered bonds and nonretail funding, which made up the gap between its lending and branch-based retail deposits. When the short-term funding market froze, the bank found itself unable to renew short-term borrowing.

What fundamental aspect of liquidity risk does this scenario most vividly illustrate?

(A) Risks of over-reliance on alternative wholesale funding and illiquid asset-backed securities.
(B) Time risk caused by borrower repayment stoppage and unexpected defaults in the mortgage sector.
(C) Idiosyncratic risk triggered exclusively by a localized cyberattack on retail branch networks.
(D) Systemic risk caused primarily by an increase in retail branch deposit withdrawals during crises.

May/June 2008

58. Read the following statements regarding the liquidity crisis of a financial institution and answer the question that follows.

I The triggering event was the public announcement by the central bank in September 2007.

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II The institution's balance sheet growth was largely funded by traditional branch-based retail deposits, which prevented an immediate collapse.

Which of the above statement(s) is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2013

59. Read the following objectives regarding the Contingency Funding Plan (CFP) and answer the question that follows.

I Identify plausible stress events.
II Evaluate those stress events under different levels of severity.
III Make a quantitative assessment of funding needs under stress events.
IV Identify potential and viable funding sources in response to a stress event.
V Ensure exclusive reliance on central bank bailout mechanisms.

Which of the above should the CFP accomplish?

(A) (I), (II), (III), and (IV)
(B) (I), (II), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

May/June 2015

60. Regarding liquidity risk tolerance, consider the following statements and answer the question that follows.

I Limits on discrete or cumulative funding mismatches over specified time horizons.
II Triggers on funding concentrations to promote dependency on a single funds provider.
III Target amounts of highly liquid asset reserves expressed as a coverage of net cash outflows.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II) are correct
(B) Only (II) and (III) are correct
(C) Only (I) and (III) are correct
(D) (I), (II), and (III) are correct

Oct/Nov 2012

61. Read the following scenario regarding contingency planning and answer the question that follows.

Bank Beta decides to activate its Contingency Funding Plan (CFP). The crisis team finds that the CFP acts independently and contradicts the bank's business continuity planning.

What principle of effective CFP formulation did Bank Beta violate?

(A) The CFP should not identify plausible stress events that could occur in the future.
(B) The CFP must solely focus on quantitative assessment, ignoring the administrative structure.
(C) The CFP should be integrated with other activities like business continuity planning.
(D) The CFP is designed exclusively for high-probability, low-impact events in retail banking.

May/June 2011

62. Read the following scenario regarding credit limits and answer the question that follows.

Bank Alpha has a significant volume of overdraft and revolving credit accounts. The ALM head proposes placing all undrawn limits into the Day 1 outflow bucket.

According to behavioral study guidelines, what is a more appropriate approach?

(A) Analyzing roll-in and roll-out behavior to identify core and volatile portions via empirical data.
(B) Placing all limits symmetrically across all time buckets without differentiation between segments.
(C) Excluding unutilized portions of revolving credits entirely from the statement as off-balance items.
(D) Assuming a zero percent invocation rate for overdrafts since they represent stable relationships.

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Oct/Nov 2020

63. Read the following scenario regarding the classification of deposits and answer the question that follows.

Bank Alpha is preparing its Statement of Structural Liquidity. The ALM team is unsure how to classify Savings Bank (SB) deposits, as they are payable on demand, but historical data shows a large portion remains stable.

If Bank Alpha cannot estimate the behavioural pattern of these SB deposits, what is the standard regulatory directive?

(A) Classify 100% of SB deposits in the 'over 5 years' bucket to reflect long-term stability.
(B) Treat 15% of SB deposits as volatile and place them in early time buckets for safety.
(C) Treat 10% as volatile across early buckets, and the core portion in the 1-3 years bucket.
(D) Classify the entire SB deposit base under the 2-7 days bucket to account for demand risk.

May/June 2022

64. Read the following scenario regarding collateral management and answer the question that follows.

During a stress event, Bank Beta's intraday liquidity management fails because the physical location of collateral prevents timely mobilization.

Which of the following principles was explicitly overlooked by Bank Beta?

(A) Incorporating liquidity costs into internal pricing and strategic business planning.
(B) Publicly disclosing information on a regular basis to maintain stakeholder transparency.
(C) Actively managing collateral positions, including tracking location for timely mobilization.
(D) Articulating a liquidity risk tolerance level appropriate for the bank's business strategy.

Oct/Nov 2023

65. Read the following scenario regarding management actions and answer the question that follows.

Over consecutive quarters, Bank Alpha notices large negative cumulative mismatches in the '8 to 14 days' time bucket.

What action should the bank's management consciously take?

(A) Convert all highly liquid assets into fixed-term 5-year loans to maximize interest margins.
(B) Minimize mismatches or manage the conscious gap by utilizing low-cost borrowing options.
(C) Completely halt the issuance of current and savings deposits to restrict inflow volatility.
(D) Seek immediate capital downgrade to trigger prompt corrective action protocols with regulators.

May/June 2016

66. Read the following scenario regarding mismatch limits and answer the question that follows.

Bank Alpha computes a net cumulative negative mismatch of 12% in the 2-7 days bucket and 18% in the 15-30 days bucket.

Based on standard prudential limits for domestic structural liquidity, what is the status of Bank Alpha's mismatches?

(A) Both buckets are within the acceptable limits.
(B) The 2-7 days bucket breaches the limit, but the 15-30 days bucket is acceptable.
(C) The 2-7 days bucket is acceptable, but the 15-30 days bucket breaches the limit.
(D) Both buckets breach the acceptable limits.

Oct/Nov 2009

67. Read the following scenario regarding funding strategy and answer the question that follows.

To combat the liquidity strain, Bank Beta initiates a "Strategic action" according to its funding strategy.

Which of the following actions taken by Bank Beta would be correctly classified as "Strategic" rather than "Tactical"?

(A) Drawing down a committed credit facility from another bank.
(B) Engaging in outright sale of highly liquid assets.
(C) Lengthening the maturities of new wholesale liabilities.
(D) Issuance of debt instruments or raising capital.

May/June 2023

68. Read the following scenario regarding market volatility and answer the question that follows.

Bank Beta operates heavily in wholesale markets. A sudden geopolitical crisis causes a drastic drop in the secondary market prices of its pledged assets, leading to margin calls.

Under Stress Testing scenarios, what parameter of Bank Beta's contingency planning is primarily being tested?

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(A) The link between reduced market liquidity and resulting constraints on funding liquidity.
(B) The impact of positive press coverage on core deposits during geopolitical instability.
(C) The operational capability of retail branch staff to process large volumes of cash.
(D) The historical inelastic behavior of retail term deposit renewals under stressed markets.

Oct/Nov 2018

69. Read the following scenario regarding liquidity gaps and answer the question that follows.
In Bank Alpha's structural liquidity statement, the 15-30 days bucket shows cash inflows of 400 Crores and cash outflows of 200 Crores.
What does this represent in terms of liquidity gap, and what is its implication?
(A) A negative gap of 200 Crores, implying the bank will face a liquidity shortfall.
(B) A positive gap of 200 Crores, indicating a surplus that could be deployed for higher yields.
(C) A neutral gap, implying exact maturity matching of all assets and liabilities.
(D) A negative gap of 600 Crores, implying a severe regulatory breach for the institution.

May/June 2007

70. Read the following scenario regarding MIS reporting and answer the question that follows.
Following a crisis, Bank Beta's ALCO reviews the events. They discover that the crisis stemmed from the idiosyncratic withdrawal of a few large corporate deposits, which were unforeseen.
To better prepare for the future, what should the ALCO incorporate into its MIS reporting?
(A) Only standard business-as-usual historical financial statements and standard auditing reports.
(B) Funding concentration reports highlighting dependence on sources sensitive to specific risks.
(C) Ratios that aggregate all deposits regardless of size, counterparty, or maturity profiles.
(D) Reports minimizing the impact of negative press coverage to keep the board optimistic.

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ANSWERS

1. (B) 10%
When banks cannot estimate behavioral patterns for Savings Bank deposits, 10% is treated as volatile and 90% as core. The volatile portion is distributed in early time buckets, while the core portion is usually placed in the 1-3 years bucket. This standardizes liquidity risk management when empirical data for specific accounts is unavailable for internal modeling purposes.

2. (C) Intraday liquidity monitoring is only relevant for banks engaged exclusively in retail banking without payment and settlement activities.
Intraday liquidity monitoring is essential for all banks regardless of their business model, especially those involved in payment and settlement activities. Effective management ensures banks meet payment obligations in real-time. Maintaining sufficient cash balances and collateral capacity is necessary to cover both expected and unexpected funding needs throughout the operating day to prevent potential systemic disruptions.

3. (C) The sudden requirement of funds to pay third parties when contingent liabilities devolve on the bank.
Call risk represents the liquidity strain arising from the sudden requirement of funds to pay third parties when contingent liabilities devolve. This occurs when letters of credit, guarantees, or other off-balance sheet commitments are invoked unexpectedly. Banks must manage this risk by estimating potential outflows and ensuring adequate liquidity is available to honor these standing commitments during the day.

4. (C) To show the effect of various possible changes in market conditions on the bank's liquidity position and recommend action to the ALCO.
The ALM Support Group prepares forecasts and simulations to evaluate how various market conditions impact the bank's liquidity position. These projections help the Asset-Liability Management Committee make informed decisions regarding business strategies. By simulating potential scenarios, the group identifies risks and recommends proactive measures to maintain stability under changing economic environments or sudden interest rate fluctuations during operations.

5. (B) It captures short-term liquidity on a dynamic basis by assessing projected business growth over a 90-day horizon.
A Dynamic Liquidity Statement captures short-term liquidity by assessing projected business growth over a 90-day horizon. Unlike the Structural Liquidity Statement, which focuses on static maturity buckets, the dynamic approach incorporates anticipated changes in asset and liability volumes. This allows banks to forecast net funding requirements and manage day-to-day liquidity more effectively based on future business plans.

6. (B) Estimating and monitoring cash flows from contingent liabilities in normal and stressed market environments.
Managing liquidity risks for off-balance sheet exposures involves estimating and monitoring cash flows from contingent liabilities under both normal and stressed environments. Banks must assess the likelihood of these exposures materializing and impacting available funds. Proactive monitoring ensures that sufficient liquidity buffers are maintained to cover potential obligations arising from special purpose vehicles or complex derivative instruments during crises.

7. (B) The risk of a bank's inability to meet cash and collateral obligations without incurring disproportionate cost.
Liquidity risk is defined as a bank's inability to meet its cash and collateral obligations as they fall due without incurring disproportionate costs. It encompasses the failure to fund increases in assets or meet obligations efficiently. Effective management requires balancing available liquid resources with potential demands for funds to

NODIA

ensure the bank remains operational during various adverse market conditions.

8. (B) The core portion of savings and current deposits may be placed in the over 1-3 years bucket.
Behavioral studies recognize that while savings and current deposits are payable on demand, a significant core portion remains stable over time. This core portion can be placed in longer time buckets, such as the 1-3 years category, for liquidity analysis. Understanding these patterns allows banks to differentiate between volatile funds needing immediate liquidity and stable funds supporting long-term assets.

9. (B) Maximize short-term profitability by liquidating long-term assets at a premium during crisis.
The primary goal of a Contingency Funding Plan is to ensure a bank can survive severe liquidity stress, not to maximize short-term profitability. CFPs identify contingent liquidity sources, designate management responsibilities, and establish crisis communication protocols. Liquidating long-term assets at a premium is generally unfeasible during a crisis, where the focus remains on maintaining operational stability and solvency.

10. (C) Capital is the resource used to absorb unexpected losses to remain solvent, while liquidity ensures cash availability to meet obligations.
Solvency and liquidity are fundamental yet distinct concepts in banking. Solvency relates to a bank's ability to absorb unexpected losses through its capital base, ensuring long-term viability. Liquidity, however, refers to having sufficient cash or easily convertible assets to meet near-term obligations as they fall due. A bank can be solvent but illiquid if its assets are inaccessible.

11. (A) 2, 4, 1, 3
Monitoring liquidity involves sequential time buckets to track cumulative negative mismatches. The shortest duration starts with the next day, followed by the 2-7 days period. Subsequently, the 8-14 days and 15-30 days buckets are analyzed. This progression allows banks to manage immediate and short-term funding needs systematically, ensuring that potential shortfalls are identified and addressed within specific regulatory timeframes.

12. (C) 2008
The Basel Committee on Banking Supervision published the Principles for Sound Liquidity Risk Management and Supervision in 2008. This publication was a response to the global financial crisis, emphasizing the need for robust liquidity frameworks. It established seventeen principles covering governance, measurement, and monitoring of liquidity risk, providing a global standard for banks and supervisors to enhance stability.

13. (A) The ratio of Temporary Assets to Volatile Liabilities with a value greater than 1 indicates a severe possibility of a liquidity problem.
The ratio of temporary assets to volatile liabilities measures a bank's ability to cover short-term funding needs. A value greater than one indicates a healthy liquidity position, as it suggests the bank has more liquid assets than volatile obligations. Conversely, a value below one signifies potential liquidity strain, as liquid resources might be insufficient to cover sudden deposit withdrawals.

14. (C) It involves the sudden withdrawal of deposits by corporate and large institutional customers without prior notice.
Idiosicsyncratic behavior in a liquidity context refers to the unexpected actions of specific depositors, such as corporate or large institutional customers. This involves the sudden withdrawal of substantial funds without prior notice, often triggered by a loss of confidence in the bank's stability. Such events can create immediate and significant funding gaps that require the bank to access emergency sources.

15. (D) Incorporate planning for these risks into the day-to-day management of sources and uses of funds.
High-probability, low-impact liquidity risks should be managed through routine, day-to-day planning of sources and uses of funds. These risks are predictable and manageable within the standard operating framework of the bank. By incorporating these into regular liquidity

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monitoring and cash flow forecasting, banks ensure that minor fluctuations do not escalate into larger problems requiring emergency interventions or contingency plans.

16. (A) The risk that a bank cannot easily offset a position at market prices due to depth or market disruption.
Market liquidity risk is the risk that a bank cannot easily offset or eliminate a financial position at the prevailing market price. This difficulty arises from insufficient market depth or disruptions that prevent the execution of trades without significantly impacting the price. It differs from funding liquidity risk, focusing instead on the ease of selling assets in secondary markets.

17. (A) Net worth
Temporary assets represent highly liquid resources available to a bank within a one-year horizon. Components include balances with other banks, investments maturing up to one year, and excess cash reserve ratio balances. Net worth, however, is a capital item representing owners' equity and is not a liquid asset intended for meeting immediate funding requirements in the structural liquidity ladder.

18. (D) 300% of the net worth
Banks with a Capital to Risk-weighted Assets Ratio at least 25% higher than the regulatory minimum of 9% are permitted an increased Inter-bank Liability limit. This higher limit is set at 300% of the bank's net worth. This regulatory provision allows well-capitalized banks greater flexibility in their wholesale funding activities, recognizing their stronger capacity to manage various financial risks.

19. (D) Banks should exclusively rely on historical data for stress scenarios while dismissing internal expert judgement.
Effective stress testing for liquidity risk must go beyond historical data to include forward-looking scenarios and internal expert judgment. Relying exclusively on past events is insufficient because market conditions and bank-specific risks evolve. Incorporating qualitative insights and hypothetical scenarios allows banks to evaluate potential adverse impacts from complex instruments and off-balance sheet items that historical datasets might not capture.

20. (A) It forecasts liquidity at different points of time by tracking cash flow mismatches using a constructed maturity ladder.
The flow approach to measuring liquidity risk involves forecasting cash inflows and outflows across various time periods. By constructing a maturity ladder, banks place assets and liabilities into specific time buckets based on their residual maturities or expected behavioral patterns. This allows management to track potential cash flow mismatches and ensure that sufficient funds are available at different times.

21. (B) 3, 1, 2
The computation of liquidity gaps under the flow approach begins by setting norms for classifying assets and liabilities based on their maturity. Once these standards are established, the bank constructs a maturity ladder by placing items into appropriate time buckets. Finally, the bank determines the deficit or surplus of funds in each individual bucket and calculates the cumulative position.

22. (C) 90 days
The Dynamic Liquidity Statement is prepared to assess a bank's net funding requirements by considering projected business growth. This statement typically covers a horizon of 90 days, providing a short-term view of liquidity needs beyond static contractual maturities. It helps the bank align its funding strategy with anticipated increases in assets and liabilities, ensuring growth is supported by adequate liquidity.

23. (D) Retail deposits are driven by service and relationship factors, making them less sensitive to market interest rate changes.
Retail deposits are generally considered a stable funding source because they are primarily driven by customer service and long-standing relationships. These depositors are typically less sensitive to changes in market interest rates compared to institutional investors. Consequently, retail funds are less likely to be withdrawn suddenly in response to minor market fluctuations, providing a predictable base for bank operations.

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24. (D) Issuance of debt instruments
Tactical actions are short-term maneuvers used to address immediate liquidity needs, such as selling liquid assets, accessing the inter-bank market, or drawing down committed facilities. In contrast, the issuance of debt instruments is considered a strategic action. Strategic actions involve long-term balance sheet restructuring and fundamental changes to the funding base, requiring more preparation than routine tactical liquidity management.

25. (B) The counterparty advance rates on various types of collateral have no influence on the amount and nature of collateral pledged.
Counterparty advance rates, or haircuts, significantly influence the amount of liquidity a bank can raise by pledging collateral. Lower advance rates mean a bank must provide more collateral to secure the same amount of funding. Factors such as the credit quality of the pledged loans and regulatory perceptions of the bank also dictate the nature and availability of these borrowings.

26. (D) The inability to meet present and future funding needs without adversely affecting operations or condition.
Funding liquidity risk is the risk that a bank will be unable to meet its present and future cash flow and collateral needs efficiently. This inability can adversely affect the bank's daily operations or overall financial condition. It focuses on the bank's capacity to settle obligations as they fall due and fund asset growth without incurring significant losses.

27. (A) The time gap between receipt of expected funds and the demand for funds to honor standing commitments.
Time risk, also known as tenor risk, refers to the uncertainty surrounding the timing of cash flows. It involves the gap between when a bank expects to receive funds and when those funds are actually required to honor standing commitments. This risk often materializes when expected inflows, such as loan repayments, are delayed, while contractual outflows must be met.

28. (A) Shocks to funding liquidity lead to asset sales, which depress asset prices and lower market liquidity, leading to higher margin calls and further increasing funding liquidity risk.
A downward liquidity spiral begins when funding shocks force banks to sell assets, which depresses market prices. Lower prices lead to higher margin calls on collateralized borrowings, further increasing funding liquidity risk. This interaction creates a feedback loop where market and funding liquidity reinforce each other's decline, potentially leading to systemic instability and severe financial distress for involved institutions.

29. (C) Dislocations in national or global financial markets
Bank-specific factors affecting liquidity are internal to the institution, such as credit rating downgrades, deteriorating asset quality, or internal system breakdowns like fraud. In contrast, dislocations in national or global financial markets are systemic factors. These external events affect the entire financial system rather than being unique to one specific bank's operational performance or internal risk management framework.

30. (D) Reviewing stress test scenarios and ensuring a well-documented Contingency Funding Plan is periodically reviewed.
The Asset-Liability Management Committee is responsible for reviewing stress test scenarios and ensuring that a well-documented Contingency Funding Plan is in place. ALCO must periodically review these plans to ensure they remain relevant to the bank's risk profile. This oversight ensures that the bank is prepared to respond effectively to various levels of stress and maintain stability.

31. (C) Asset securitization — Strategic action
Asset securitization is classified as a strategic action because it involves fundamentally restructuring the balance sheet by converting illiquid assets into marketable securities. Unlike tactical actions, which are short-term responses to immediate needs, strategic actions like securitization or raising capital are planned long-term initiatives. These measures aim to diversify funding sources and improve the overall liquidity profile of institutions.

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32. (B) (I), (III), and (V)
Tactical actions during a liquidity shock are immediate, short-term measures to secure funds. These include drawing down committed facilities, selling liquid assets, and seeking growth in wholesale deposits. Raising capital or expanding the retail deposit base are generally considered strategic actions due to the longer timeframe required for implementation. Tactical maneuvers focus on rapid mobilization of liquidity to address urgent shortfalls.

33. (B) P-2, Q-1, R-4, S-3
In banking, the Board of Directors formulates the liquidity risk strategy, while the Risk Management Committee evaluates overall risks. The Asset-Liability Management Committee decides the desired maturity profile and mix of assets and liabilities. The ALM Support Group provides operational support by preparing forecasts and simulations that show the impact of changing market conditions on the bank's liquidity position.

34. (D) Assertion (A) is false, but Reason (R) is true.
Relying predominantly on a single source of wholesale funding is a poor strategy as it increases vulnerability to systemic market disruptions. A bank should instead diversify its funding sources to ensure continuous liquidity. Over-reliance on non-deposit funding can be risky because these sources may evaporate quickly during crises. Diversification across different instruments and counterparties is essential for robust management.

35. (B) Only (II) is correct
Securitization involves converting on-balance sheet assets, such as loans, into marketable securities, not off-balance sheet items. When executed effectively, the proceeds from these sales serve as a material source for meeting ongoing and future funding needs. This process allows a bank to free up capital and improve liquidity by transferring the risks and cash flows of specific assets.

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36. (A) A market shock causing severe funding constraints on banks dependent on short-term markets.
This scenario illustrates how a market-wide shock, such as the freezing of the interbank market due to subprime mortgage issues, creates funding constraints for banks. Even institutions without direct exposure to the distressed assets can suffer if they rely on short-term markets for liquidity. This highlights the interdependence of market liquidity and the ability of individual banks to secure funding.

37. (A) P-2, Q-4, R-3, S-1
Principle 2 requires banks to clearly articulate their liquidity risk tolerance. Principle 4 focuses on incorporating liquidity costs and risks into internal pricing. Principle 11 mandates having a formal contingency funding plan to address potential stress events. Finally, Principle 12 emphasizes the maintenance of a cushion of high-quality liquid assets to ensure the bank can withstand significant liquidity disruptions.

38. (D) (I), (II), (III), and (IV)
Regulatory guidelines establish specific tolerance levels for negative cumulative mismatches in the structural liquidity statement. The limits are 5% for the next day, 10% for 2-7 days, 15% for 8-14 days, and 20% for 15-30 days. Adhering to these thresholds ensures that banks maintain a prudent liquidity profile and are not excessively exposed to short-term funding gaps.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Banks are highly leveraged institutions where the failure to maintain liquidity can trigger a systemic crisis. This is because banking stability relies on depositor trust. If depositors believe they cannot withdraw their funds at will, they may rush to withdraw money, leading to a bank run. This loss of faith undermines the bank's operations and can cause widespread instability.

40. (D) Call Money Borrowing Limit — Not to exceed 100% of capital funds on a fortnightly average.
The call money borrowing limit is based on a fortnightly average not exceeding 100% of

capital funds, but there is also a specific daily cap that must be followed. Specifically, the daily limit should not exceed 125% of capital funds. Banks must carefully monitor their daily and average borrowings to stay within the prescribed capital-linked boundaries and avoid breaches.

41. (B) Clear crisis communication is vital, as perception impacts depositor trust and liquidity strains.
The scenario demonstrates that how a bank communicates during a crisis is critical, as public perception directly impacts depositor trust. Improperly managed announcements can trigger panic and bank runs, exacerbating liquidity strains. A Contingency Funding Plan must include a clear communication strategy to manage information flow to stakeholders, ensuring that transparency does not inadvertently lead to further instability.

42. (C) P-4, Q-1, R-3, S-2
External factors affecting liquidity include geographical issues like deteriorating local economic conditions and systemic events such as major changes in global economies. Financial sector factors involve scandals that affect public confidence across many firms. Operational factors encompass disturbances to payment systems or local natural disasters. Categorizing these factors helps banks identify potential external threats to their overall funding stability.

43. (D) (I), (II), (III), and (IV)
Comprehensive stress testing must incorporate both funding and market liquidity risks, acknowledging their interaction. Scenarios should include significant events like capital downgrades and their impact on funding constraints. Results must be thoroughly discussed by the ALCO to ensure management understands the vulnerabilities. This integrated approach allows the bank to develop effective responses and maintain resilience against severe financial disruptions.

44. (D) (I), (II), and (III)
A sound liquidity risk management process requires several key components, including active management of intraday liquidity and collateral. It must also feature an independent internal audit to evaluate the adequacy of risk management processes. Furthermore, having a comprehensive contingency funding plan is essential for responding to stress events. Together, these elements ensure the bank can meet obligations under various conditions.

45. (C) Weak customer-branch relationships reduced loyalty, making funds rate-sensitive and prone to flight.
Retail deposits gathered through postal or telephone channels often lack the strong relationship bonds found in traditional branch-based banking. Without a physical connection or loyalty to a specific branch, these depositors are more sensitive to interest rate changes and negative news. During a crisis, such funds are prone to rapid flight, making the bank's funding base less stable than expected.

46. (B) P-2, Q-3, R-4, S-1
Idiosyncratic behavior is triggered by sudden large withdrawals without notice. Funding risk relates to the renewal patterns of deposits deviating from historical trends. Time risk occurs when there is a gap between expected inflows and actual demand due to contractual failures. Call risk is triggered by the unexpected devolution of contingent liabilities, requiring the bank to pay third parties immediately.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Stability in banking requires both capital adequacy and sound liquidity management. Capital serves as a financial cushion to absorb unexpected losses, ensuring the bank remains solvent in the long term. Liquidity ensures that the bank has enough cash or liquid assets to meet its immediate obligations. Together, they protect the institution from different types of failure and maintain stability.

48. (B) Earning Assets — Includes Intangible assets
Earning assets refer to those that generate income for the bank, such as loans and investments. Intangible assets, such as goodwill, do not generate direct interest or fee income and are not considered earning assets in liquidity

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metrics. In contrast, temporary assets include short-term funds, and core deposits represent stable funding sources like long-term deposits and net worth of the bank.

49. (B) (I), (II), (IV), and (V)
Negative impacts on liquidity are driven by factors like deteriorating credit quality, rating downgrades, and public cybersecurity incidents. Rising reputation risks also lead to fund withdrawals. Positive press coverage, however, typically enhances depositor confidence and would not negatively impact liquidity. Understanding these triggers allows banks to monitor for early warning signs and activate their contingency funding plans before crises develop.

50. (A) Only (I) and (III) are correct
The standard Inter-bank Liability limit is 200% of a bank's net worth, and call money borrowings on a fortnightly average must not exceed 100% of capital funds. However, the IBL limit typically excludes collateralized borrowings from certain providers and specific refinance facilities. This exclusion recognizes that secured funding and central bank facilities carry different risk profiles than unsecured inter-bank liabilities.

51. (D) Long-term mortgage assets funded by short-term liabilities, creating severe funding mismatches.
Expanding long-term mortgage assets while relying on a traditional funding base that may be short-term creates a significant maturity mismatch. This failure in structural balance sheet management leaves the bank vulnerable if short-term funding becomes unavailable or more expensive. Effective liquidity management requires aligning maturity profiles of assets and liabilities to prevent severe funding gaps during market stress or interest rate shifts.

52. (D) Temporary Assets to Total Assets — 40%
The ratio of temporary assets to total assets measures the proportion of a bank's portfolio held in highly liquid forms. An industry average of approximately 40% is common, indicating a balanced approach between liquid holdings and higher-yielding, less liquid loans. Other ratios, such as core deposits to total assets, typically have different industry benchmarks depending on the specific business model.

53. (B) Only (II) is correct
Retail deposits are generally less sensitive to market interest rate changes because they are driven by service and relationships. Conversely, institutional deposits are often obtained in bulk and are highly sensitive to the bank's financial health. Institutional depositors tend to react much faster than retail customers to any deterioration in a bank's condition, making them a more volatile funding source.

54. (D) Assertion (A) is false, but Reason (R) is true.
Market liquidity and funding liquidity are not independent; they are deeply interconnected. A decline in market liquidity forces asset sales at lower prices, which then triggers margin calls. These calls increase the need for cash, thereby heightening funding liquidity risk. This interdependence creates a downward spiral where each risk type exacerbates the other, potentially leading to a severe liquidity crisis.

55. (B) Only (I), (II), and (III)
An effective intraday liquidity strategy requires active monitoring of settlement activities and maintaining sufficient cash or overdraft capacity. Banks must also ensure they have adequate collateral pledged to the central bank for unexpected needs. Banning intraday trading is not a standard strategy, as such activities are essential for modern banking operations and market liquidity, provided they are managed with appropriate risk controls.

56. (A) P-3, Q-4, R-2, S-1
Behavioral studies help banks understand the stability of different items. For demand deposits, the goal is to identify core versus volatile portions. For term deposits, banks assess renewal and premature withdrawal rates. Contingent liabilities are studied to estimate outflow percentages from guarantee invocations. For overdrafts, the objective is to find the core and volatile portions of sanctioned credit limits.

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57. (A) Risks of over-reliance on alternative wholesale funding and illiquid asset-backed securities.
This scenario highlights the risks of over-reliance on wholesale funding sources like covered bonds. When the short-term market freezes, a bank that cannot cover its lending through stable retail deposits faces a severe liquidity crisis. This emphasizes the importance of diversifying funding sources and not becoming overly dependent on market-based borrowing, which can evaporate quickly during periods of financial stress.

58. (A) Only (I) is correct
The crisis at certain institutions in 2007 was often triggered by public announcements regarding emergency support, which damaged depositor confidence. In many such cases, the institutions' growth was not funded by traditional branch-based deposits but rather by more volatile wholesale markets. This mismatch between long-term lending and short-term market funding made them particularly vulnerable when those funding channels froze.

59. (A) (I), (II), (III), and (IV)
A Contingency Funding Plan must identify stress events, evaluate them by severity, and quantitatively assess funding needs. It should also identify viable alternative funding sources. Relying exclusively on central bank bailouts is not a sound practice; a robust plan emphasizes self-sufficiency through various internal and market-based options. This ensures the bank can respond effectively to liquidity drains without external intervention.

60. (C) Only (I) and (III) are correct
Liquidity risk tolerance involves setting limits on funding mismatches and maintaining target levels of liquid asset reserves. However, triggers should be designed to discourage, not promote, dependency on a single funds provider. Diversification is a key principle of risk management. By setting clear limits and reserve targets, banks ensure they remain within acceptable risk boundaries aligned with their overall business strategy.

61. (C) The CFP should be integrated with other activities like business continuity planning.
Effective contingency funding planning requires integration with other bank activities, such as business continuity planning. If the CFP acts independently or contradicts other emergency protocols, it can lead to confusion and inefficiency during a real crisis. Coordination ensures that the bank's response is unified, addressing both the financial and operational aspects of a disruption to maintain systemic stability.

62. (A) Analyzing roll-in and roll-out behavior to identify core and volatile portions via empirical data.
Rather than assuming all undrawn limits will be used immediately, banks should use behavioral studies to analyze historical data on credit limit utilization. By observing roll-in and roll-out patterns, the bank can identify the core portion that remains undrawn and the volatile portion likely to be used. This empirical approach provides a more realistic assessment of potential future liquidity outflows.

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63. (C) Treat 10% as volatile across early buckets, and the core portion in the 1-3 years bucket.
According to standard guidelines, if a bank cannot estimate the behavioral pattern of Savings Bank deposits, it should treat 10% as the volatile portion. This volatile amount is placed in early time buckets, while the remaining 90% is considered core and placed in the 1-3 years bucket. This provides a conservative and standardized way to account for potential withdrawals.

64. (C) Actively managing collateral positions, including tracking location for timely mobilization.
Sound liquidity management requires banks to actively track the physical location of their collateral to ensure it can be mobilized quickly during a stress event. If collateral cannot be moved in time due to logistical issues, it fails to provide the necessary liquidity support. This oversight highlights a breakdown in the operational aspects of collateral management, essential for securing emergency funding.

65. (B) Minimize mismatches or manage the conscious gap by utilizing low-cost borrowing options.
When a bank identifies large negative cumulative mismatches, management should take conscious steps to minimize these gaps. This can be achieved by adjusting the maturity profile of assets and liabilities or by securing reliable, low-cost borrowing to cover the shortfall. Proactive gap management ensures the bank does not face a liquidity crunch when obligations in that specific time bucket fall due.

66. (B) The 2-7 days bucket breaches the limit, but the 15-30 days bucket is acceptable.
Standard prudential limits for domestic structural liquidity specify a maximum negative mismatch of 10% for the 2-7 days bucket and 20% for the 15-30 days bucket. Bank Alpha's 12% mismatch in the 2-7 days bucket exceeds the limit, representing a regulatory breach. However, its 18% mismatch in the 15-30 days bucket remains within the acceptable 20% threshold defined by guidelines.

67. (D) Issuance of debt instruments or raising capital.
Issuing debt instruments or raising capital are considered strategic actions because they involve long-term changes to the bank's capital structure and funding base. Tactical actions, such as selling liquid assets or drawing on credit lines, are short-term measures for immediate liquidity needs. Strategic actions require extensive planning, aiming to permanently improve the bank's liquidity and solvency profile over a longer horizon.

68. (A) The link between reduced market liquidity and resulting constraints on funding liquidity.
The scenario tests the link between market liquidity and funding liquidity. A drop in asset prices reduces the value of collateral, leading to margin calls that increase the bank's need for cash. Stress testing helps banks understand how market disruptions can translate into direct funding pressures, allowing them to prepare contingency plans that address the potential for these interrelated liquidity spirals.

69. (B) A positive gap of 200 Crores, indicating a surplus that could be deployed for higher yields.
In the 15-30 days bucket, inflows of 400 Crores exceed outflows of 200 Crores, resulting in a positive gap of 200 Crores. This indicates a surplus of funds during that period. A positive gap suggests that the bank has excess liquidity that could be deployed into interest-earning assets or used to cover potential deficits in other time buckets, enhancing overall profitability.

70. (B) Funding concentration reports highlighting dependence on sources sensitive to specific risks.
To better manage idiosyncratic risks, ALCO should incorporate funding concentration reports into its MIS. These reports identify dependencies on specific large depositors or funding sources that are sensitive to the bank's reputation or financial condition. By monitoring these concentrations, the bank can diversify its funding base and develop targeted contingency plans to mitigate the impact of sudden withdrawals by customers.

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CHAPTER 06
Credit Risk Management Framework

Oct/Nov 2014

1. Who is responsible for implementing the credit risk strategy approved by the Board?
(A) The Board of Directors
(B) The Chief Economist
(C) The external banking supervisors
(D) Senior management of the bank

May/June 2021

2. Which of the following statements about loan policy is incorrect?
(A) The risk management philosophy of the bank is revealed through the risk management policy statement.
(B) The loan policy sets standards for portfolio composition, individual credit decisions, fair lending, and compliance.
(C) Because risk-bearing capacity is identical across all banks, the form and contents of loan policies utilize a single universal model document.
(D) The loan policy describes the course of risk-taking activities to maximize risk-adjusted return.

Oct/Nov 2006

3. How is Risk Appetite defined?
(A) The absolute currency amount of risk that a company wants to take to achieve corporate strategy.
(B) The process by which risks that are inherent in the credit portfolio are managed and controlled.
(C) The quantum of risk that the bank intends to accept within its total risk-bearing capacity.
(D) The formal commitment of the board of directors to administer an efficient risk management system.

May/June 2019

4. What is the most appropriate primary purpose of conducting due diligence in a credit proposal?
(A) To guarantee that a loan will never default under any circumstances.
(B) To immediately transfer the credit risk to a third-party risk underwriter.
(C) To avoid relationships that can negatively impact bank operations or earnings.
(D) To ensure that all documentation is standardized without any policy exceptions.

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Oct/Nov 2025

5. What is the fundamental requirement for the independence of the Credit Risk Management Department (CRMD)?
(A) It must be established independently of the Treasury unit to prevent conflicts in liquidity management.
(B) It must be independent of Credit Administration to ensure objective risk measurement and management.
(C) It must operate entirely outside the jurisdiction and oversight of the Risk Management Committee.
(D) It must be primarily responsible for direct business development and relationship management duties.

May/June 2012

6. What is the best strategy for handling policy and underwriting exceptions?
(A) Automatically rejecting any loan application that requires a standard policy exception.
(B) Identifying, documenting, and ensuring attention matches the materiality of the exception.
(C) Allowing exceptions only for the relationship management team without formal documentation.
(D) Relegating all substantive exceptions to the lowest operational level for faster processing.

Oct/Nov 2018

7. What is the precise definition of credit risk?

(A) The risk that fair value of debt securities fluctuates due to market movements in credit spreads.
(B) The potential loss arising when a counterparty fails to meet their specific contractual obligations.
(C) The uncertainty regarding the total recovery of the principal loan amount when a default event occurs.
(D) The risk impacting the global financial system caused by broad, uncontrollable external economic forces.

May/June 2023

8. Which statement accurately reflects the management of exceptions to credit policy?
(A) Standardization of risk management processes requires that businesses must always be done strictly on dotted lines with zero deviations.
(B) Deviations from underwriting guidelines should be well documented and justified, requiring empowerment to deviate from policies.
(C) Policy and underwriting exceptions are conditions in rejected loans that failed to meet the strategic objectives.
(D) Loan administration relies on the Treasury department to systematically identify document exceptions.

Oct/Nov 2009

9. The internal and legal documents on various types of loans include all of the following as internal documents, EXCEPT:
(A) Internal risk rating reports
(B) Mortgages and security agreements
(C) Credit memoranda
(D) Financial analysis and appraisals

May/June 2016

10. How does portfolio credit risk analysis differ from single borrower credit risk analysis?
(A) Obligor risk focuses on individual default probabilities, while portfolio risk evaluates market trends.
(B) Obligor risk evaluates exposure to sovereign entities, while portfolio risk evaluates small businesses.
(C) Obligor risk assesses single borrower loss, while portfolio risk assesses aggregate correlations.
(D) Obligor risk cannot be mitigated, while portfolio risk is controlled through rigorous credit rationing.

Oct/Nov 2023

11. Consider the following operations/systems steps of an effective credit risk management framework:
I Monitoring of risks
II Identification of risks
III Management/control risks
IV Measurement of risks
Which of the following represents the logical sequential order of these steps?
(A) (II), (IV), (III), (I)
(B) (I), (II), (III), (IV)
(C) (IV), (III), (II), (I)
(D) (II), (I), (IV), (III)

May/June 2022

12. Which of the following entities are considered among the most important suppliers of short-term credit for business requirements in most countries?
(A) Equity brokerage firms
(B) Insurance underwriters
(C) Commercial banks
(D) Central planning agencies

Oct/Nov 2020

13. Identify the incorrect statement about the building blocks of credit risk management.
(A) Operations and Systems exclude the identification and measurement of risks.
(B) Policy and Strategy form a foundational building block of the credit risk management framework.
(C) Organizational Structure is recognized as a distinct building block.
(D) The framework requires senior management and the board to develop medium- and long-term strategic plans.

May/June 2011

14. Identify the correct statement regarding spread risk.
(A) Spread risk functions as the mathematical complement of the Loss Given Default measure.
(B) Spread risk measures the historical likelihood of joint default within a specific time period.

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(C) Spread risk is the risk of rating deterioration and bond value loss due to a rising yield spread.
(D) Spread risk is the yield difference between bonds of different maturities with identical quality.

Oct/Nov 2012

15. What is the most appropriate primary purpose of conducting due diligence in a credit proposal?
(A) By completely halting the issuance of all new credit facilities.
(B) By concentrating loans in a single highly profitable industry sector.
(C) By exclusively financing sovereign and local government institutions.
(D) By extending credit to a large number of customers in various sectors.

May/June 2015

16. Which of the following defines Recovery Risk?
(A) The risk associated with the uncertainty of recovering full loan amounts after a default has occurred.
(B) The probability that a specific individual or corporation will fail to meet a debt payment obligation.
(C) The risk of a bond's value decreasing as a result of a rise in the yield spread of the instrument.
(D) The potential for localized losses to grow large enough to impact the core capital of a lending bank.

Oct/Nov 2013

17. A bank with high risk appetite will prefer to do business predominantly in all of the following areas, EXCEPT:
(A) Exclusive lending to financially strong, government-backed sovereign institutions
(B) Financial instruments trading
(C) Gold and futures trading
(D) Real estate finance

May/June 2008

18. Which committee devises the policy and strategy for integrated risk management containing various risk exposures of the bank including credit risk?
(A) Risk Management Committee of the Board (RCBOD)
(B) Credit Risk Management Department (CRMD)
(C) Asset Liability Management Committee (ALCO)
(D) Credit Risk Management Committee (CRMC)

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Oct/Nov 2017

19. Identify the incorrect statement regarding the functions of the Credit Risk Management Committee (CRMC).
(A) The CRMC is responsible for the implementation of the credit risk policy approved by the Board.
(B) The CRMC monitors credit risk on a bank-wide basis and ensures compliance with limits.
(C) The CRMC decides the delegation of credit approving powers and prudential limits on large credit exposures.
(D) The CRMC directly undertakes the daily relationship management phase and business development for all retail loans.

May/June 2006

20. Which of the following statements correctly describes the laddered approach to loan approval?
(A) It delegates sanctioning limits to individuals while referring larger amounts to Credit Committees.
(B) It relies exclusively on the committee method, removing all individual signature authority levels.
(C) It allows simple transactions to bypass formal approval limits to increase operational throughput.
(D) It diminishes individual accountability and slows down the bank's general market responsiveness.

Oct/Nov 2008

21. Consider the following phases of the credit administration process:
I Portfolio management phase
II Relationship management phase
III Transaction management phase
Which of the following represents the logical sequential order of these phases?
(A) (I), (II), (III)
(B) (II), (III), (I)
(C) (III), (II), (I)

(D) (II), (I), (III)

May/June 2024

22. Which specific database have banks developed to perceive early alerts for taking appropriate measures to mitigate risk in time?
(A) Loss Given Default (LGD) accounts
(B) Special Mention Accounts (SMA)
(C) Asset Liability Management (ALM) accounts
(D) Default Correlation (DC) accounts

Oct/Nov 2021

23. How does a bank's credit culture influence its risk profile?
(A) It relies on written policies to enforce compliance while ignoring unwritten norms or traditions.
(B) It is a set of static regulatory rules that determines the exact path of a bank's growth strategy.
(C) It prioritizes aggressive growth while disregarding the monitoring of administrative risk systems.
(D) It shapes the credit process; a weak culture leads to assuming risks that exceed bank objectives.

May/June 2013

24. The functions of the Credit Risk Management Department (CRMD) include all of the following, EXCEPT:
(A) Measure, control and manage credit risk on a bank-wide basis within the limits set by the Board/CRMC.
(B) Enforce compliance with the risk parameters and prudential limits.
(C) Lay down risk assessment systems and develop MIS.
(D) Formulate the macroeconomic monetary policy for the banking sector.

Oct/Nov 2015

25. Identify the incorrect statement regarding the forms of credit risk.
(A) Default risk is measured by the likelihood an individual or company will not make contractual payments.
(B) Concentration risk results from having a number of borrowers whose fortunes are affected by disparate, uncorrelated factors.
(C) Recovery risk is associated with the uncertainty of recovery of the full amount of the loan when default occurs.
(D) Correlation risk denotes a measure of default dependency between different borrowers with common risk characteristics.

May/June 2020

26. What is the definition of Due Diligence?
(A) The formal legal process of risk transfer from a primary risk taker to a secondary underwriter.
(B) The ongoing internal effort to improve sensitivity toward impending risks and general staff awareness.
(C) The specific delegated authority to approve credit or change credit terms based on internal limits.
(D) The bank's process to identify and evaluate potential risks in a proposal that impact business viability.

Oct/Nov 2005

27. Which of the following best describes the historical emphasis on controlling credit risk?
(A) Controlling the quality of individual loan approvals and managing the performance of loans.
(B) Computing the credit risk of aggregate exposure of the portfolios.
(C) Focusing entirely on algorithmic high-frequency trading limits.
(D) Delegating all loan approvals to a single centralized committee.

May/June 2017

28. Why is unsystematic risk considered controllable by a banking institution?
(A) It is borrower-specific, measurable via credit ratings, and manageable through sector diversification.
(B) It is driven by global socio-political factors such as international wars and broad economic sanctions.
(C) It encompasses exogenous forces that affect all market participants, making it difficult to mitigate.
(D) It is synonymous with systemic risk and triggers mass defaults during prolonged economic recessions.

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Oct/Nov 2024

29. The sound practices of credit risk management specifically address all of the following areas, EXCEPT:

(A) Establishing an appropriate credit risk environment.

(B) Maintaining an appropriate credit administration, measurement and monitoring process.

(C) Guaranteeing a zero-default rate across the entire loan portfolio.

(D) Ensuring adequate controls over credit risk.

May/June 2010

30. Identify the correct statement regarding systematic risks.

(A) Systematic risks are industry-specific and can be mitigated by lending across various sectors.

(B) Systematic risks are unique to individual borrowers and are categorized as controllable risks.

(C) Systematic risks at the portfolio level cancel each other out and can be diversified away.

(D) Systematic risks impact the whole economy and are triggered by factors like economic recession.

Oct/Nov 2011

31. Identify the correct pair of organizational functions.

(A) Chief Economist - Heads the Risk Management Committee of the Board (RCBOD)

(B) Credit Administration Department - Devises the policy for integrated risk management

(C) Board of Directors - Fixes the earning targets of the bank from undertaking credit risk

(D) Line Management - Approves the bank's credit granting criteria

May/June 2009

32. Consider the following statements concerning the functions of the Credit Risk Management Committee (CRMC):

I Be responsible for the implementation of the credit risk policy/strategy approved by the Board.

II Monitor credit risk on a bank-wide basis and ensure compliance with limits.

III Recommend to the Board clear policies on standards for presentation of credit proposals.

IV Decide prudential limits on large credit exposures and standards for loan collateral.

V Conduct the daily relationship management phase and structural business development for retail branches.

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (V)

(B) (I), (II), (IV), and (V)

(C) (I), (II), (III), and (IV)

(D) (II), (III), (IV), and (V)

Oct/Nov 2019

33. Match the items in List I with those in List II.

List I: Organizational Bodies

P. Board of Directors

Q. RCBOD

R. CRMC

S. CRMD

List II: Primary Responsibilities

1. Devises policy and strategy for integrated risk management
2. Decides prudential limits on large credit exposures
3. Approves the credit risk management policy
4. Lays down risk assessment systems and develops MIS

(A) P-3, Q-1, R-2, S-4

(B) P-1, Q-3, R-4, S-2

(C) P-3, Q-2, R-1, S-4

(D) P-2, Q-4, R-3, S-1

May/June 2025

34. The following question consists of two statements, one labeled as 'Assertion (A)' and the other as 'Reason (R)'. Examine these two statements carefully and select the correct answer.

Assertion (A): Deviations from underwriting guidelines should be completely forbidden to maintain the standardization of risk management processes.

Reason (R): Underwriting guidelines are the primary means by which the bank steers lending decisions toward planned strategic

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objectives and maintains desired levels of risk.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2007

35. Consider the following statements:
I Borrower-specific risk can be measured by using credit rating and tracking the borrower-rating movements.
II Systematic risks can be entirely cancelled out and diversified away at the portfolio level.
Which of the above statements is/are correct?
(A) Both (I) and (II) are correct.
(B) Both (I) and (II) are incorrect.
(C) (I) is correct, but (II) is incorrect.
(D) (I) is incorrect, but (II) is correct.

May/June 2014

36. In the case of Bank XYZ, which has concentrated $500 million of its loan portfolio in a single large textile conglomerate, this exposure directly exposes the bank to which specific form of credit risk?
(A) Concentration risk
(B) Spread risk
(C) Recovery risk
(D) Economic risk

Oct/Nov 2016

37. Match the items in List I with those in List II.
List I: Forms of Credit Risk
P. Default risk
Q. Recovery risk
R. Spread risk
S. Correlation risk
List II: Descriptions
1. Difference in yield between bonds of similar maturity
2. Complement of Loss Given Default measure
3. Likelihood of joint default
4. Likelihood an individual will not make contractual payments

(A) P-4, Q-2, R-1, S-3
(B) P-1, Q-4, R-3, S-2
(C) P-4, Q-3, R-2, S-1
(D) P-2, Q-1, R-4, S-3

May/June 2018

38. Consider the following statements regarding the loan approval process:
I A loan that starts out bad is likely to stay that way, making the loan approval process a foremost means to control loan quality.
II The individual signature authority system is more timely and establishes clear accountability.
III Laddered or joint authorities combine elements of committee and individual systems.
IV Simple and short-tenor transactions with a high-quality counterparty must exclusively be approved by senior management committees.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

Oct/Nov 2022

39. The following question consists of two statements, one labeled as 'Assertion (A)' and the other as 'Reason (R)'. Examine these two statements carefully and select the correct answer.
Assertion (A): Controlling credit risk only at the borrower level is not enough to effectively protect a bank.
Reason (R): Assessing the relationships among portfolio segments enables a portfolio manager to capture early indications of emerging risk.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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May/June 2005

40. Identify the incorrect statement regarding credit limits and underwriting criteria.
(A) Limits on aggregate loans represent the maximum loss a company is prepared to withstand.
(B) Underwriting criteria describe acceptable credit structures and permissible collateral types.
(C) Loan pricing principles state that interest rates should cover the bank's cost of funds and overhead.
(D) A commitment limit is much easier to develop without any historical data on usage.

Oct/Nov 2010

41. In the scenario of Alpha Bank, which Board level subcommittee (including the CEO and heads of various risk committees) should be tasked with devising the policy and strategy for integrated risk management?
(A) Asset Liability Management Committee
(B) Risk Management Committee of the Board (RCBOD)
(C) Credit Risk Management Department (CRMD)
(D) Credit Risk Management Committee (CRMC)

May/June 2007

42. Match the items in List I with those in List II.
List I: Credit Administration Phases
P. Relationship management
Q. Transaction management
R. Portfolio management
S. Credit risk mitigation
List II: Corresponding Activities
1. Organising all inputs keeping industry risk profile in view
2. Monitoring of problem loans at a macro level
3. Risk assessment, structuring facilities, and loan pricing
4. Business development
(A) P-4, Q-3, R-2, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-2, Q-1, R-4, S-3
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2018

43. Consider the following statements regarding underwriting criteria and exceptions:
I Underwriting is a process of risk transfer from a risk taker to an underwriter.
II The price of underwriting is the risk premium.
III Margin requirements should operate completely independent of the marketability of the security.
IV In most banks, loan administration is the control point for loan documentation.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (I), (II), and (IV)
(D) (II), (III), and (IV)

May/June 2014

44. Consider the following statements regarding the Board of Directors' role in credit risk management:
I The Board is responsible for the oversight of the credit granting function.
II The Board approves the bank's credit granting criteria including terms and conditions.
III The Board regularly reviews the bank's credit risk management policy at least annually.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II) are correct.
(B) Only (I) and (III) are correct.
(C) Only (II) and (III) are correct.
(D) (I), (II), and (III) are correct.

Oct/Nov 2005

45. In the case of Bank XYZ, the risk stemming from internal management disputes and labor strikes specific to the textile conglomerate is classified as:
(A) Socio-political risk
(B) Exogenous risk
(C) Borrower-specific default risk
(D) Systemic risk

May/June 2023

46. Match the items in List I with those in List II.
List I: Risk Types
P. Socio Political Risks

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Q. Business Risk
R. Common risk factors between industries
S. Fluctuation in fair value due to yield changes

List II: Broad Classifications
1. Spread Risk
2. Correlation risk
3. Unsystematic Risk
4. Systematic Risk

(A) P-4, Q-3, R-2, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-1, Q-2, R-3, S-4
(D) P-4, Q-1, R-3, S-2

Oct/Nov 2024

47. The following question consists of two statements, one labeled as 'Assertion (A)' and the other as 'Reason (R)'. Examine these two statements carefully and select the correct answer.

Assertion (A): A bank driven to achieve aggressive growth targets requires more detailed credit policies and more controlling administrative and monitoring systems.

Reason (R): Such growth-oriented banks may approach lending more aggressively by lending to borrowers who pose a higher repayment risk, making a cautious aggression towards risk management necessary.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2021

48. Identify the incorrect pair of loan approval authorities and their characteristics.

(A) Committee method - Advantageous because knowledge can be shared
(B) Committee method - May diminish accountability and often slows responsiveness
(C) Individual signature authority - Can create undue credit risk if experience is inadequate
(D) Laddered approach - Completely eliminates the need for individual functionaries

Oct/Nov 2008

49. Consider the following statements regarding credit risk definitions and concepts:

I Default risk is measured by the likelihood an individual or company will not make contractual payments.
II Recovery risk is the complement of the Loss Given Default measure.
III Credit spread risk is the risk that the fair value of securities will fluctuate because of changes in credit spread.
IV Concentration risk results from having a number of borrowers whose fortunes are affected by common factors.
V Default Correlation measures the likelihood of joint default within the period of consideration.

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), (IV), and (V)
(B) (I), (II), (IV), and (V)
(C) (I), (III), (IV), and (V)
(D) (II), (III), (IV), and (V)

May/June 2016

50. Consider the following statements about Risk Appetite:

I The declaration of risk appetite sets the platform for determining the business mix and selecting risk grades of loans.
II Banks with relatively low capital and average risk management capabilities generally pursue a highly aggressive risk appetite in futures trading.
III The SWOT analysis of the bank and risk appetite has to be well aligned.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II) are correct.
(B) Only (I) and (III) are correct.
(C) Only (II) and (III) are correct.
(D) (I), (II), and (III) are correct.

Oct/Nov 2012

51. At Alpha Bank, which entity is formally responsible for providing final approval for the credit risk management policy and fixing the earning targets within the risk tolerance threshold?

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(A) Credit Risk Management Department (CRMD)
(B) Risk Management Committee of the Board (RCBOD)
(C) Credit Risk Management Committee (CRMC)
(D) Board of Directors

May/June 2025

52. Identify the correct pair of risk concepts.
(A) Borrower Specific Risk - Systematic Risk
(B) Concentration Risk - Uncontrollable macroeconomic forces
(C) Obligor Risk - Exposure to a group of borrowers across industries
(D) Portfolio Credit Risk - Exposure to a group of borrowers across industries or sectors

Oct/Nov 2014

53. Consider the following statements:
I A portfolio credit risk analysis focuses on computing the credit risk of aggregate exposure, capturing correlations between obligor defaults and migrations.
II Management of credit risk at the portfolio level entirely eliminates the necessity of controlling the quality of individual loan approvals.
Which of the above statements is/are correct?
(A) Both (I) and (II) are correct.
(B) Both (I) and (II) are incorrect.
(C) (I) is correct, but (II) is incorrect.
(D) (I) is incorrect, but (II) is correct.

May/June 2011

54. The following question consists of two statements, one labeled as 'Assertion (A)' and the other as 'Reason (R)'. Examine these two statements carefully and select the correct answer.
Assertion (A): Unsystematic risks are considered to be uncontrollable systemic risks that affect the financial system as a whole.
Reason (R): Unsystematic risks are largely industry-specific and/or firm-specific, and can be diversified by extending credit to a large number of customers across various sectors.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2019

55. Consider the following statements regarding credit risk management strategy:
I The credit risk strategy should spell out clearly the organization's credit appetite and the acceptable level of risk-reward trade-off.
II The strategy should be viable in the long run and take into account the cyclical aspects of the economy.
III Senior management of the bank shall be responsible for implementing the credit risk strategy approved by the Board.
IV The credit risk strategy is formulated completely independent of the bank's willingness to grant loans based on geographical location and currency.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV)
(B) (I), (II), and (III)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

May/June 2017

56. Match the items in List I with those in List II.
List I: Strategic Concepts
P. Strategy
Q. Financial Goals
R. Risk Appetite
S. Loan Policy
List II: Core Focus Areas
1. Quantum of risk the bank intends to accept within its capacity
2. Medium and long-term plans consistent with risk tolerance
3. Business plans setting realistic targets using earnings and ROE
4. Primary means to guide lending activities and set standards
(A) P-2, Q-3, R-1, S-4
(B) P-3, Q-2, R-4, S-1
(C) P-1, Q-4, R-2, S-3
(D) P-4, Q-1, R-3, S-2

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Oct/Nov 2021

57. Consider the following case study: Bank XYZ operates in a developing economy. Recently, the national government introduced significant changes to industrial policies, while global trade sanctions were imposed on key export sectors. Concurrently, Bank XYZ has concentrated $500 million of its loan portfolio in a single large textile conglomerate, which is facing internal management disputes and localized labor strikes.

The impact of the global trade sanctions and national policy changes on Bank XYZ's portfolio represents which type of risk?

(A) Systematic Risk
(B) Business Risk
(C) Unsystematic Risk
(D) Correlation Risk

May/June 2007

58. Consider the following statements:

I Credit culture encompasses the tangible written policies and procedures, and the intangibles such as traditions.
II Values and behaviors that are rewarded become the standards and will assume more importance than written policies and procedures.

Which of the above statements is/are correct?

(A) Both (I) and (II) are correct.
(B) Both (I) and (II) are incorrect.
(C) (I) is correct, but (II) is incorrect.
(D) (I) is incorrect, but (II) is correct.

Oct/Nov 2015

59. Consider the following statements about portfolio risk and reward:

I Bank loan portfolios should return profits commensurate with their risk.
II Volatility in banks' earnings usually has been linked to the loan portfolio.
III A common underlying factor for weak risk management is the tendency to underestimate or underprice credit risk.
IV Individual credits and portfolio segments should be priced to provide reasonable shareholder returns.
V Adequate capital and allowance levels must be maintained while achieving shareholder returns.

Which of the above statement(s) is/are correct?

(A) (I), (III), and (IV), and (V)
(B) (I), (II), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (IV), and (V)

May/June 2022

60. Consider the following statements regarding limits on aggregate loans and commitments:

I Limits represent the absolute currency amount of risk that a company wants to take to achieve corporate strategy.
II A bank will find it much easier to develop a commitment limit if it has historical data on usage of its commitments.
III Geographical limits are strictly isolated from the objective of serving the credit needs of the bank's community.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II) are correct.
(B) Only (I) and (III) are correct.
(C) Only (II) and (III) are correct.
(D) (I), (II), and (III) are correct.

Oct/Nov 2020

61. For Beta Bank, the phase of credit administration that entails monitoring the loan portfolio at a macro level and managing problem loans is the:

(A) Relationship management phase
(B) Transaction management phase
(C) Portfolio management phase
(D) Due diligence phase

May/June 2013

62. If Omega Commercial Bank requires a deep analysis of financial statements to determine the risk premium associated with a new $10 million loan, this requirement reflects the bank's:

(A) Underwriting criteria
(B) Relationship management phase
(C) Portfolio management phase
(D) Liquidity profile setup

Oct/Nov 2006

63. The newly established independent department at Alpha Bank tasked with enforcing compliance with risk parameters, developing MIS, and laying down risk assessment systems is the:

(A) Credit Administration Department

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(B) Treasury Department
(C) Credit Risk Management Department (CRMD)
(D) Board of Directors

May/June 2009

64. The comprehensive examination process initiated by Gamma Bank to identify actual or potential risks before sanctioning funds to a new corporate client is formally known as:
(A) Exceptional underwriting
(B) Default Correlation
(C) Due Diligence process
(D) Recovery Risk mitigation

Oct/Nov 2013

65. The top management's declaration regarding the quantum of risk the bank intends to accept within its total risk-bearing capacity is termed as its:
(A) Portfolio Correlation
(B) Risk Appetite
(C) Default Likelihood
(D) Loss Given Default

May/June 2005

66. The system Omega Commercial Bank uses, where proposals are sanctioned by individual functionaries up to their delegated power and higher amounts by committees, is formally known as:
(A) The Solo Approach
(B) The Grid Approach
(C) The Third Party Approach
(D) The Laddered Approach

Oct/Nov 2017

67. A decrease in the value of corporate bonds held by Gamma Bank due to a widening difference between the yield on those bonds and the risk-free rate is a materialization of:
(A) Default risk
(B) Recovery risk
(C) Concentration risk
(D) Spread risk

May/June 2018

68. At Beta Bank, establishing absolute currency limits on the aggregate volume of outstanding loans and commitments serves to:
(A) Represent the maximum loss the company is prepared to withstand to achieve corporate strategy.
(B) Eliminate the various systematic risks currently originating from the macroeconomic environment.
(C) Replace the need for standard individual loan underwriting criteria during the approval process.
(D) Ensure all borrower-specific risks are transferred to third-party guarantors and underwriters.

Oct/Nov 2023

69. If a client at Omega Commercial Bank requests a waiver on interim financial statements, constituting a policy exception, the credit policy guidelines dictate that:
(A) It should be rejected as businesses must always be done on dotted lines.
(B) It should be documented, justified, and handled based on its materiality.
(C) It should be verbally approved by the manager without any formal reporting.
(D) It should bypass administration and be approved by the Board without analysis.

May/June 2012

70. If Gamma Bank discovers that multiple borrowers in its portfolio share common risk factors that could lead to simultaneous defaults, it is measuring the likelihood of:
(A) Spread risk
(B) Correlation risk
(C) Recovery risk
(D) Unsystematic Business Risk

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ANSWERS

1. (D) Senior management of the bank
Senior management holds the primary responsibility for executing and implementing the credit risk strategy that has been formally approved by the Board of Directors. They ensure that the bank's daily operations align with the defined risk tolerance and strategic objectives. This involves translating high-level board directives into actionable operational procedures across the entire banking institution.

2. (C) Because risk-bearing capacity is identical across all banks, the form and contents of loan policies utilize a single universal model document.
Loan policies are not uniform because every banking institution possesses a unique risk-bearing capacity, market position, and strategic focus. Each bank must tailor its specific loan policy to reflect its distinct financial strength and corporate objectives. Therefore, using a single universal model document is inappropriate for managing the diverse risks and internal capacities within different banks.

3. (C) The quantum of risk that the bank intends to accept within its total risk-bearing capacity.
Risk appetite represents the specific level of risk an institution is willing to assume to achieve its strategic objectives and financial goals. It is defined within the boundaries of the bank's total risk-bearing capacity. This measure ensures that the organization does not exceed its capital strength while pursuing market opportunities and managing its various credit exposures.

4. (C) To avoid relationships that can negatively impact bank operations or earnings.
The primary purpose of conducting thorough due diligence is to identify and evaluate potential risks associated with a credit proposal before funds are committed. By assessing borrower viability and transaction structure, banks can avoid entering into relationships that might harm their financial stability or operational integrity. This proactive process is essential for maintaining a healthy and sustainable loan portfolio.

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5. (B) It must be independent of Credit Administration to ensure objective risk measurement and management.
Maintaining an independent Credit Risk Management Department is vital for ensuring that risk measurement and management remain objective and unbiased. This separation from credit administration and business development units prevents conflicts of interest and ensures that risk assessments are conducted without pressure from lending targets. Such independence is a fundamental requirement for a robust and effective risk management framework.

6. (B) Identifying, documenting, and ensuring attention matches the materiality of the exception.
Effective risk management requires that all policy and underwriting exceptions are clearly identified and formally documented. The level of scrutiny and approval for these deviations should be proportional to their materiality and potential impact on the bank's risk profile. This systematic approach ensures that risks are transparently justified and monitored by appropriate levels of management or credit committees.

7. (B) The potential loss arising when a counterparty fails to meet their specific contractual obligations.
Credit risk is fundamentally defined as the possibility of financial loss resulting from a borrower's inability or unwillingness to fulfill their contractual debt obligations. This risk encompasses any failure to make timely payments of principal or interest as agreed upon in the credit contract. It remains the most significant risk faced by commercial banks and other lending financial institutions.

8. (B) Deviations from underwriting guidelines should be well documented and justified, requiring empowerment to deviate from policies.
While credit policies provide a standard framework, certain transactions may require deviations from established guidelines. Such exceptions must be well-documented and supported by strong justifications that align with the bank's strategic goals. Managing these deviations effectively requires a formal process where specific officials or committees are empowered to approve exceptions based on their complexity, risk level, and materiality.

9. (B) Mortgages and security agreements
Internal documents typically include risk rating reports, credit memoranda, and financial analyses used for internal decision-making and monitoring. In contrast, mortgages and security agreements are legal documents that establish the bank's claim on collateral and define the rights of the parties involved. These legal instruments are external to the bank's internal analytical reports and serve as enforceable contracts in court.

10. (C) Obligor risk assesses single borrower loss, while portfolio risk assesses aggregate correlations.
Single borrower credit risk analysis focuses on evaluating the probability of default and potential loss for an individual obligor. Conversely, portfolio credit risk analysis examines the aggregate exposure of a group of loans, specifically capturing the correlations between different borrowers. This macro-level assessment allows managers to understand how risks are distributed across the entire portfolio and identify emerging systemic trends.

11. (A) (II), (IV), (III), (I)
A logical credit risk management framework begins with the identification of risks inherent in the portfolio. Once identified, these risks must be measured to quantify potential impacts. Following measurement, management and control strategies are implemented to mitigate the identified risks. Finally, ongoing monitoring of risks ensures that the framework remains effective and responsive to changing market conditions and borrower behaviors.

12. (C) Commercial banks
Commercial banks play a pivotal role in the economy by acting as the primary suppliers of short-term credit for various business requirements. They provide essential funding for working capital, inventory, and operational expenses through products like overdrafts and short-term loans. This credit availability is crucial for the smooth functioning of trade and industry across different sectors and geographic regions globally.

13. (A) Operations and Systems exclude the identification and measurement of risks.
The building blocks of an effective credit risk management framework include policy and strategy, organizational structure, and operations and systems. Contrary to the incorrect statement, the operations and systems component is specifically designed to facilitate the identification, measurement, monitoring, and control of risks. These systems provide the necessary infrastructure and data for senior management to make informed credit-related decisions.

14. (C) Spread risk is the risk of rating deterioration and bond value loss due to a rising yield spread.
Spread risk arises when the yield difference between a debt instrument and a risk-free benchmark widens, leading to a decrease in the bond's market value. This widening spread often reflects a deterioration in the issuer's credit quality or a general increase in market risk aversion. Consequently, even without a formal default, the fair value of the security fluctuates significantly.

15. (D) By extending credit to a large number of customers in various sectors.
Unsystematic risks are specific to individual borrowers or industries and can be effectively mitigated through diversification. By extending credit to a wide range of customers across different economic sectors, a bank ensures that localized losses do not severely impact its overall capital. This strategy reduces the dependency on any single industry and helps maintain a stable and balanced loan portfolio.

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16. (A) The risk associated with the uncertainty of recovering full loan amounts after a default has occurred.
Recovery risk focuses on the potential shortfall in retrieving the outstanding loan amount after a borrower has defaulted. It is essentially the complement of the Loss Given Default measure, representing the uncertainty regarding the actual value realized from collateral or other recovery efforts. Managing this risk involves careful assessment of collateral quality, legal enforceability, and the time required for liquidation.

17. (A) Exclusive lending to financially strong, government-backed sovereign institutions
Banks with a high risk appetite typically engage in more volatile activities such as financial instruments trading, real estate finance, and futures trading to achieve higher returns. In contrast, lending exclusively to financially strong, government-backed sovereign institutions represents a low-risk strategy. Such high-quality assets offer greater security and stability, which does not align with the aggressive profit-seeking profile of high-risk-appetite institutions.

18. (A) Risk Management Committee of the Board (RCBOD)
The Risk Management Committee of the Board is responsible for devising the comprehensive policy and strategy for integrated risk management within a bank. This committee ensures that all risk exposures, including credit risk, are managed in a holistic and consistent manner. By setting the overarching framework, the RCBOD provides strategic direction and oversight to ensure the institution's long-term financial stability.

19. (D) The CRMC directly undertakes the daily relationship management phase and business development for all retail loans.
The Credit Risk Management Committee primarily focuses on high-level oversight, including implementing credit policies, monitoring bank-wide risk, and deciding on prudential limits for large exposures. It does not engage in operational tasks such as daily relationship management or direct business development for retail loans. These customer-facing activities are typically handled by line management and branch staff rather than a committee.

20. (A) It delegates sanctioning limits to individuals while referring larger amounts to Credit Committees.
The laddered approach to loan approval balances individual accountability with collective oversight by delegating specific sanctioning limits to individual officers based on their experience and seniority. For credit requests exceeding these individual limits, the proposal is escalated to higher-level committees. This tiered system improves operational efficiency for smaller transactions while ensuring rigorous scrutiny for larger, more complex credit exposures.

21. (B) (II), (III), (I)
The credit administration process begins with the relationship management phase, focusing on business development and customer engagement. This is followed by the transaction management phase, which involves risk assessment, facility structuring, and loan pricing for specific deals. Finally, the portfolio management phase entails macro-level monitoring of the entire loan book and the management of problem loans to ensure overall health.

22. (B) Special Mention Accounts (SMA)
Special Mention Accounts serve as an early warning system for banks to identify loans that exhibit potential weaknesses but have not yet defaulted. By categorizing these accounts separately, banks can implement timely corrective actions and risk mitigation strategies. This proactive database helps managers perceive early alerts regarding deteriorating credit quality, allowing for better preservation of the bank's asset quality and financial performance.

23. (D) It shapes the credit process; a weak culture leads to assuming risks that exceed bank objectives.
A bank's credit culture encompasses both its formal written policies and its informal traditions and behaviors. This culture fundamentally shapes the credit process and determines how

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risks are perceived and managed. A weak credit culture can lead to excessive risk-taking and the neglect of monitoring systems, potentially resulting in losses that exceed the bank's strategic objectives and risk tolerance levels.

24. (D) Formulate the macroeconomic monetary policy for the banking sector.
The Credit Risk Management Department is responsible for internal functions such as measuring and controlling bank-wide credit risk, enforcing compliance with limits, and developing risk assessment systems. It does not formulate macroeconomic monetary policy, as that is the exclusive responsibility of the central bank or national monetary authority. The CRMD's role is strictly confined to managing the specific risks within its bank.

25. (B) Concentration risk results from having a number of borrowers whose fortunes are affected by disparate, uncorrelated factors.
Concentration risk results when a bank has many borrowers whose fortunes are tied to common risk factors, leading to correlated defaults. If borrowers were affected by disparate and uncorrelated factors, the bank would benefit from diversification rather than face concentration risk. Managing this risk requires identifying commonalities in the portfolio, such as industry, geographic location, or specific economic dependencies.

26. (D) The bank's process to identify and evaluate potential risks in a proposal that impact business viability.
Due diligence is a systematic and comprehensive process undertaken by banks to evaluate the viability of a credit proposal. It involves identifying potential financial, operational, and market risks that could affect the borrower's ability to repay. By conducting this thorough assessment before approving a loan, banks can make informed decisions and ensure that the transaction aligns with their risk tolerance.

27. (A) Controlling the quality of individual loan approvals and managing the performance of loans.
Historically, credit risk management focused heavily on the assessment and approval of individual loans to maintain high asset quality. Banks primarily emphasized the performance of single obligors and their ability to meet contractual obligations. While portfolio-level analysis has become increasingly important in modern banking, the traditional foundation remains rooted in ensuring that each individual credit decision is sound and well-managed.

28. (A) It is borrower-specific, measurable via credit ratings, and manageable through sector diversification.
Unsystematic risk is considered controllable because it pertains to specific borrowers or industries rather than the entire economy. Banks can measure this risk using credit ratings and tracking individual borrower movements. Furthermore, by diversifying the loan portfolio across various sectors and geographic regions, institutions can significantly reduce the impact of unsystematic losses, making it a manageable component of overall credit risk.

29. (C) Guaranteeing a zero-default rate across the entire loan portfolio.
Sound credit risk management practices focus on establishing a proper risk environment, maintaining robust administration and monitoring processes, and ensuring adequate controls. However, it is impossible to guarantee a zero-default rate in any lending activity, as risk is inherent to banking. Effective management aims to keep defaults within acceptable limits and ensure that the bank is adequately compensated for the risks taken.

30. (D) Systematic risks impact the whole economy and are triggered by factors like economic recession.
Systematic risks represent exogenous forces that affect the entire financial system and cannot be diversified away. These risks are triggered by broad macroeconomic events such as economic recessions, international conflicts, or large-scale political instability. Since these factors impact all participants in the market simultaneously, they require banks to maintain adequate capital buffers and stress-testing frameworks to ensure resilience against widespread shocks.

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31. (C) Board of Directors - Fixes the earning targets of the bank from undertaking credit risk
The Board of Directors holds the ultimate responsibility for setting the bank's strategic direction, which includes fixing earning targets from credit-taking activities. They define the risk tolerance and approve the overall credit risk management policy. This role ensures that the bank's pursuit of profit is balanced with its capacity to absorb potential losses, maintaining the long-term solvency and stability of the institution.

32. (C) (I), (II), (III), and (IV)
The Credit Risk Management Committee is responsible for implementing approved credit policies, monitoring bank-wide risk, and recommending standards for credit proposals. It also decides on prudential limits for large exposures. However, it does not manage daily retail relationship tasks, which are operational duties. Correct identification of CRMC functions is essential for understanding the hierarchical structure of risk governance within a bank.

33. (A) P-3, Q-1, R-2, S-4
Organizational responsibilities are distributed as follows:
P. The Board of Directors approves the high-level credit risk management policy.
Q. The RCBOD devises the strategy for integrated risk management across various exposures.
R. The CRMC sets prudential limits for large credit exposures and monitors compliance.
S. The CRMD establishes risk assessment systems and develops management information systems.

34. (D) Assertion (A) is false, but Reason (R) is true.
While underwriting guidelines are indeed the primary means to steer lending toward strategic objectives, it is incorrect to say that deviations should be completely forbidden. Flexibility is often required to address unique transaction characteristics. However, these deviations must be carefully justified and documented. Therefore, while the reason accurately describes the role of guidelines, the assertion demanding zero deviations is false.

35. (C) (I) is correct, but (II) is incorrect.
Borrower-specific risk can be measured through credit ratings and tracking rating movements over time. However, systematic risks cannot be entirely cancelled out or diversified away at the portfolio level because they affect the whole economy. While diversification reduces unsystematic risk, systematic risk remains a constant factor that banks must manage through capital adequacy and other high-level strategic risk mitigation techniques.

36. (A) Concentration risk
Bank XYZ faces concentration risk because it has a significant portion of its loan portfolio allocated to a single large borrower or industrial group. This lack of diversification means that any adverse event affecting the textile conglomerate will have a disproportionately large impact on the bank's overall financial health. Managing such exposures requires setting strict limits on the maximum volume of credit.

37. (A) P-4, Q-2, R-1, S-3
Credit risk forms are described by these characteristics:
P. Default risk reflects the likelihood of a borrower failing to make contractual payments.
Q. Recovery risk is defined as the mathematical complement of the Loss Given Default.
R. Spread risk involves yield differences between bonds of similar maturity.
S. Correlation risk measures the likelihood of multiple joint defaults within a period.

38. (A) (I), (II), and (III)
Loan quality is best controlled during the approval process since bad loans rarely improve over time. Individual signature authority systems offer timeliness and clear accountability, while laddered systems combine individual and committee oversight. However, simple and short-tenor transactions do not exclusively require senior committee approval; they are often handled by individual functionaries to maintain operational efficiency and market responsiveness.

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39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Managing credit risk solely at the borrower level is insufficient because it ignores the interactions and correlations between different segments of the portfolio. Assessing these relationships allows managers to detect emerging risks that might not be visible when looking at individual loans in isolation. Therefore, portfolio-level analysis is essential for a comprehensive risk management strategy that protects the bank from systemic losses.

40. (D) A commitment limit is much easier to develop without any historical data on usage.
Developing a commitment limit is actually more difficult without historical data on usage, as banks need to understand how much of their commitments are typically drawn. Other statements accurately describe that aggregate limits represent maximum loss tolerance, underwriting criteria define acceptable credit structures, and pricing must cover costs and overhead. Accurate historical data is fundamental for setting realistic and effective limits.

41. (B) Risk Management Committee of the Board (RCBOD)
The Risk Management Committee of the Board is the appropriate subcommittee for devising the policy and strategy for integrated risk management. It consists of high-level executives, including the CEO, and ensures that various risk exposures are managed under a unified framework. This committee provides the necessary oversight to align the bank's risk-taking activities with its overarching strategic goals and financial stability.

42. (A) P-4, Q-3, R-2, S-1
Credit administration phases involve distinct activities:
P. Relationship management is centered on business development and customer acquisition.
Q. Transaction management involves risk assessment, facility structuring, and appropriate loan pricing.
R. Portfolio management focuses on macro-level monitoring and handling problem loans.
S. Credit risk mitigation requires organizing inputs while considering the specific industry risk profile.

43. (C) (I), (II), and (IV)
Underwriting involves transferring risk for a premium, and loan administration serves as the control point for documentation. These are fundamental aspects of the credit process. However, margin requirements should not be independent of marketability; rather, they must directly reflect the liquidity and price volatility of the collateral. Correctly understanding these relationships is crucial for maintaining a secure and well-documented credit portfolio.

44. (D) (I), (II), and (III) are correct.
The Board of Directors plays a comprehensive role in credit risk management by overseeing the credit granting function and approving the specific criteria and terms for loans. Furthermore, the Board must regularly review the bank's credit risk management policy, typically on an annual basis. This high-level involvement ensures that the bank's lending practices remain consistent with its risk appetite and regulatory requirements.

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45. (C) Borrower-specific default risk
Risks such as internal management disputes and labor strikes are unique to the specific borrower and do not affect the entire economy. Therefore, these are classified as borrower-specific default risks. Unlike systemic or socio-political risks that impact all participants, these factors can be identified through credit analysis of the individual obligor and managed through diversification within the bank's broader loan portfolio.

46. (A) P-4, Q-3, R-2, S-1
Risk types are classified as follows:
P. Socio-political risks are broad factors categorized under systematic risk.
Q. Business risks specific to a firm are part of unsystematic risk.
R. Common factors between industries define the nature of correlation risk.

S. Fluctuations in fair value due to yield changes describe spread risk.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Banks pursuing aggressive growth often target borrowers with higher repayment risks, necessitating more detailed credit policies and rigorous monitoring systems. This cautious aggression ensures that while the bank expands its portfolio, it maintains tight controls to mitigate the increased potential for losses. Therefore, the need for robust administrative systems is a direct consequence of the higher risk profile associated with rapid growth.

48. (D) Laddered approach - Completely eliminates the need for individual functionaries
The laddered approach does not eliminate the need for individual functionaries; instead, it utilizes them by delegating specific approval limits based on seniority. This system combines the speed of individual authority for smaller loans with the thoroughness of committee reviews for larger ones. Claiming that it removes individuals from the process is incorrect, as they remain essential components of the tiered approval structure.

49. (A) (I), (II), (III), (IV), and (V)
These statements collectively provide an accurate overview of key credit risk concepts. Default risk pertains to payment failure, recovery risk complements Loss Given Default, and spread risk involves value fluctuations due to yield changes. Concentration risk arises from common risk factors, while default correlation measures joint default likelihood. Understanding these diverse components is essential for a comprehensive and effective risk management framework.

50. (B) Only (I) and (III) are correct.
Risk appetite declarations provide the foundation for determining business mix and loan risk grades, and they must be closely aligned with the bank's SWOT analysis. However, banks with low capital and average risk management capabilities should not pursue aggressive risk appetites in volatile areas like futures trading. Such behavior would be irresponsible and likely lead to severe financial distress or insolvency.

51. (D) Board of Directors
The Board of Directors is the ultimate authority responsible for providing final approval of the credit risk management policy. They also establish the earning targets and set the overall risk tolerance levels for the institution. By fulfilling these duties, the Board ensures that the bank's management operates within a clearly defined and approved framework that prioritizes long-term financial stability and safety.

52. (D) Portfolio Credit Risk - Exposure to a group of borrowers across industries or sectors
Portfolio credit risk refers to the aggregate exposure a bank has to a diverse group of borrowers across various industries and sectors. This macro-level view allows the bank to analyze correlations and concentration risks that might not be evident in single-borrower assessments. Properly managing portfolio risk involves ensuring that the loan book is sufficiently diversified to withstand shocks in specific economic areas.

53. (C) (I) is correct, but (II) is incorrect.
Portfolio credit risk analysis is vital for capturing correlations between obligor defaults and migrations across the entire exposure. However, this macro-level management does not eliminate the need for rigorous individual loan approval processes. Controlling the quality of each credit remains a fundamental requirement, as the health of the portfolio is ultimately built upon the soundness of its individual component loans.

54. (D) Assertion (A) is false, but Reason (R) is true.
Unsystematic risks are not uncontrollable systemic risks; they are borrower-specific or industry-specific and can be mitigated through diversification. The reason correctly states that these risks can be reduced by extending credit to a large number of customers across different sectors. Therefore, while the assertion mischaracterizes unsystematic risk as systemic, the reasoning provides an accurate description of its nature and management.

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55. (B) (I), (II), and (III)
An effective credit risk strategy must define the organization's appetite and risk-reward trade-off while accounting for economic cycles. Senior management is then responsible for implementing this board-approved strategy. However, the strategy is not formulated independent of geographical or currency preferences; these factors are integral to defining where and how the bank is willing to grant credit within its risk framework.

56. (A) P-2, Q-3, R-1, S-4
Strategic concepts and their focus areas:
P. Strategy involves medium and long-term plans consistent with risk tolerance.
Q. Financial goals set realistic business targets using earnings and ROE.
R. Risk appetite defines the quantum of risk the bank intends to accept.
S. Loan policy serves as the primary means to guide lending activities and standards.

57. (A) Systematic Risk
The impact of global trade sanctions and national policy changes represents systematic risk because these factors affect the entire economic environment and financial system. These external, exogenous forces are beyond the control of individual banks and cannot be diversified away. Managing such risks requires broad strategic planning, maintaining strong capital buffers, and conducting stress tests to ensure institutional resilience during shocks.

58. (A) Both (I) and (II) are correct.
Credit culture is a combination of formal written policies and informal traditions within an institution. The values and behaviors that are actually rewarded by management often become the true operational standards, sometimes carrying more weight than the written guidelines themselves. A healthy credit culture ensures that staff at all levels prioritize sound risk management over short-term gains or aggressive volume targets.

59. (B) (I), (II), (III), (IV), and (V)
These statements accurately reflect the relationship between portfolio risk and reward. Loan portfolios should generate profits commensurate with their risks, and their volatility often drives earnings fluctuations. Weak risk management frequently stems from underpricing credit risk. Therefore, pricing must provide reasonable shareholder returns while maintaining adequate capital. This holistic approach ensures that the bank remains profitable and solvent across various economic conditions.

60. (A) Only (I) and (II) are correct.
Limits on aggregate loans represent the maximum currency amount of risk an institution is willing to take to achieve its strategy. Furthermore, having historical usage data makes it much easier for a bank to develop effective commitment limits. However, geographical limits are not strictly isolated from community needs; rather, they must balance the bank's risk diversification goals with its commitment to serving local customers.

61. (C) Portfolio management phase
The portfolio management phase involves the macro-level monitoring of the entire loan book and the active management of problem loans. Unlike the transaction phase, which focuses on individual deals, this phase evaluates the overall health and diversification of the bank's credit exposures. It ensures that emerging risks are identified early and that appropriate actions are taken to maintain the desired risk-return profile.

62. (A) Underwriting criteria
Omega Commercial Bank's requirement for deep financial analysis to determine risk premiums reflects its underwriting criteria. These criteria establish the standards for evaluating borrower creditworthiness and defining acceptable terms for loan facilities. By applying rigorous analysis during the underwriting process, the bank ensures that each loan is structured correctly and that the interest rate appropriately compensates for the assessed level of risk.

63. (C) Credit Risk Management Department (CRMD)
The Credit Risk Management Department is the independent unit responsible for enforcing risk parameters and developing management information systems. It lays down the systems for risk assessment and ensures that the bank's

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credit activities remain within the prudential limits set by the Board. This independence is crucial for providing an objective view of the bank's risk profile, separate from business development pressures.

64. (C) Due Diligence process
Gamma Bank's comprehensive examination of a potential corporate client is known as the due diligence process. This systematic evaluation aims to identify all material risks that could impact the borrower's business viability and ability to repay the loan. By conducting this process before sanctioning funds, the bank can make an informed credit decision and structure the facility to mitigate any identified potential weaknesses.

65. (B) Risk Appetite
Top management's declaration regarding the quantum of risk the bank is willing to accept is defined as its risk appetite. This statement sets the boundaries for the bank's lending activities and guides the selection of business sectors and risk grades. It ensures that the bank's pursuit of profit is conducted within its total risk-bearing capacity, protecting the institution's capital and long-term stability.

66. (D) The Laddered Approach
The laddered approach is a credit approval system where individual officers have delegated authority to sanction loans up to specific limits. Higher-value proposals that exceed these individual limits are then escalated to committees for more rigorous collective review. This tiered structure balances the need for operational efficiency with the requirement for thorough oversight on larger and more complex credit exposures within the bank.

67. (D) Spread risk
Spread risk occurs when the market value of a bond decreases due to an increase in the yield spread over the risk-free rate. This widening spread typically reflects a change in the perceived credit quality of the issuer or a shift in market risk premiums. Even if the issuer does not default, the fluctuations in spread can cause significant volatility in the bank's portfolio valuation.

68. (A) Represent the maximum loss the company is prepared to withstand to achieve corporate strategy.
Establishing absolute currency limits on total loans and commitments allows a bank to define the maximum loss it is prepared to withstand while pursuing its corporate strategy. These limits act as a cap on total exposure, ensuring that the institution does not overextend itself relative to its capital base. This high-level control is essential for maintaining the overall safety and soundness of the bank.

69. (B) It should be documented, justified, and handled based on its materiality.
When a client requests a waiver that constitutes a policy exception, the bank must formally document and justify the decision to deviate from established guidelines. The handling of such exceptions should be proportional to their materiality and potential impact on the credit's risk profile. This transparent process ensures that deviations are not arbitrary and are reviewed by officials with the appropriate delegated authority.

70. (B) Correlation risk
Correlation risk is the likelihood that multiple borrowers within a portfolio will default simultaneously due to shared risk factors. By identifying these commonalities, the bank can better understand how localized economic shocks impact overall asset quality. Managing this risk is key to portfolio analysis, helping set limits that prevent excessive exposure to interlinked groups of borrowers.

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CHAPTER 07
Obligor Borrower Risk

Oct/Nov 2015

1. Analyze the following business scenario to answer the question: XYZ Corp has been classified under "High Operating Risk and Low Financial Risk". The company operates in a highly cyclical sector and is currently facing a recession-induced drop in demand. However, it operates with minimal external finance and holds strong cash reserves. As a credit officer, what is the most appropriate assessment of this borrower?

(A) The borrower should be avoided as high operating risks lead to immediate default regardless of current financial strength.
(B) The firm should be downgraded because declining sales will automatically eliminate its cash reserves within a single quarter.
(C) The borrower exhibits symptoms of ignoring the finance function and is overloaded with significant external debt.
(D) The firm has uncertain business prospects, but its strong financial position may enable it to survive the cyclical downturn.

May/June 2008

2. Which of the following pairs concerning the sources of external risk is incorrectly matched?

(A) Monetary Policy Tools – Changes in interest rates, Forex controls, and buying/selling of treasury securities
(B) Fiscal Policy Tools – Direct and indirect taxation, surcharges, levies, and government borrowings
(C) Current Account – Purchase/sale of assets, loan/gold transactions, and foreign investments
(D) Political Risk – Confiscation, currency repatriation restrictions, and changes in government policies

Oct/Nov 2023

3. Consider the following statements regarding the interaction between operating risk and financial risk:

I A firm with Low Operating Risk and Medium Financial Risk is classified as having Low Credit Risk (CR).
II A firm with Medium Operating Risk and High Financial Risk is classified as having Very High Credit Risk (CR).

Which of the statements is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

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May/June 2014

4. Industry risk arises mainly from three sources. Which of the following statements correctly describe these sources?

I Risk emanating from external sources includes government actions like lowering import duty or imposing corporate tax.
II Industry Specific Risks include the bargaining power of suppliers and buyers, and fierce competition from new entrants.
III Risks Emanating from Industry Drivers are entirely dependent on internal management decisions and not on demand factors.

Which combination of statements is correct?

(A) (I) and (II)
(B) (II) and (III)
(C) (I) and (III)
(D) (I), (II) and (III)

Oct/Nov 2007

5. How is a "technical recession" most commonly defined in the media?

(A) A sustained period of inflation exceeding GDP growth over four consecutive quarters.
(B) Two consecutive quarters of negative growth in real GDP.
(C) A stage marking the end of declining business activity and a transition to expansion.
(D) A scenario where the highest levels of

unemployment occur concurrently with the highest production levels.

May/June 2021

6. Match the stages of the Industry Life Cycle with their defining characteristics:

List I: Stages of the Industry Life Cycle

P. Rapid Growth Stage
Q. Maturity growth
R. Stabilization
S. Decline

List II: Defining Characteristics

1. Better and new substitutes cause sales growth to give way to negative growth.
2. The limited number of players face little competition, and operating risks are low as sales and profits grow.
3. Industry growth is almost identical to that of the economy, and profit margins become more or less stagnant.
4. Growth in sales and profits decelerates as demand slackens, and profitability drops to normal levels due to new entrants.

(A) P-4, Q-2, R-1, S-3
(B) P-2, Q-4, R-3, S-1
(C) P-3, Q-1, R-4, S-2
(D) P-1, Q-3, R-2, S-4

Oct/Nov 2019

7. Credit events of a non-financial nature are defined as the risk arising from a credit event or situation which can adversely impact a company's ability to achieve its business objectives. What are these risks known as?

(A) Counterparty risks
(B) Business or operating risks
(C) Systematic risks
(D) Industry specific risks

May/June 2005

8. The National Income (NI) or Gross National Product is usually expressed by which of the following equations?

(A) $Y = C + I + G - (X + M)$
(B) $Y = C + I + G + (X - M)$
(C) $Y = C - I - G + (X + M)$
(D) $Y = (C + I) \times G + (X - M)$

Oct/Nov 2022

9. Consider the following statements regarding the Balance of Payments and Exchange Rates:

I The balance of payments measures how much a country has to pay to the rest of the world or vice versa.
II The capital account is usually larger than the current account and comprises trade in goods and services.
III Repatriation of employee compensation, gifts, and donations fall under the current account.
IV Foreign exchange inflows must be increased to keep the current account deficit low.
V Currency devaluation of a competing nation effectively results in the depreciation of local currency.

Which combination of statements is correct?

(A) (I), (II) and (IV)
(B) (I), (III) and (IV)
(C) (II), (IV) and (V)
(D) (I), (III) and (V)

May/June 2017

10. Identify the incorrect statement regarding the different risk levels of an obligor.

(A) Firms with Low Operating Risk and Low Financial Risk are of the highest quality and are usually characterized by stable market conditions and good management.
(B) For firms with Medium Operating Risk and High Financial Risk, streamlining the finance function can help improve their creditworthiness in most instances.
(C) A decline in the creditworthiness of a borrower is an abrupt and instantaneous process and is never a gradual migration from a low-risk asset to a higher risk level.
(D) In the High Operating Risk and High Financial Risk category, capacity to repay credit is so impaired that collection of the claim is doubtful.

Oct/Nov 2011

11. Some experts identify "5Ms" as the classic concepts of factors of production. Which of the following accurately represents the 5Ms?

(A) Money, Man, Machines, Material, and Marketing
(B) Method, Machines, Material, and Management
(C) Markets, Man, Machines, Material, and Management
(D) Money, Man, Machines, Material, and Management

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May/June 2024

12. Match the following Operating Risk and Financial Risk combinations with their corresponding Credit Risk (CR) classifications:
List I: Risk Combinations
P. Low Operational Risk, High Financial Risk
Q. Medium Operational Risk, Low Financial Risk
R. High Operational Risk, Medium Financial Risk
S. High Operational Risk, High Financial Risk
List II: Credit Risk (CR) Classifications
1. Low CR
2. Very High CR
3. Medium High CR
4. High CR
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2006

13. Read the following scenario and answer the question: Gamma Electronics produces both durable and non-durable consumer goods. The country's economy has recently entered a strong growth phase, resulting in rising National Income. How should a bank's credit risk analyst interpret this macroeconomic development for Gamma Electronics?
(A) Economic growth will result in higher sales for products, triggering demand for components and higher profits.
(B) The bank should expect a decline in sales as consumers will increase savings rather than spending on goods.
(C) The bank should restrict credit because economic growth reduces potential growth rates in manufacturing.
(D) Gamma Electronics will inevitably collapse because growth exposes internal flaws of non-durable goods.

May/June 2011

14. Consider the following scenario: During an ongoing economic recovery phase, Beta Retailers decides to aggressively expand its store network, hiring additional staff and taking on fresh credit to build inventory. Assuming the economy successfully transitions to the peak phase, what is the most likely outcome of Beta Retailers' decisions?
(A) The expansion will weaken the company as demand remains depressed and credit losses mount significantly.
(B) The business will face a cash flow crisis because economic recovery is characterized by rising unemployment.
(C) The investments will likely lead to increased sales and profits, provided over-capacity is avoided.
(D) The firm will be forced to shut down because only pharmaceutical and food industries perform well here.

Oct/Nov 2018

15. Analyze the following company profile: A newly established tech company is operating in a niche industry where the market for its products is still very small and prospective customers need to be heavily educated. The company is facing initial hesitations from buyers, resulting in doubtful profitability and low sales. According to the industry life cycle model, how should a bank evaluate the credit risk of this company?
(A) The company is in the Stabilization stage, and its risk is low because sales are moving in tandem with the economy.
(B) The company is in the Maturity growth stage, where growth in sales and profits is decelerating due to slackening demand.
(C) The company is in the Rapid Growth stage, and increasing market demand ensures considerable business with negligible operating risk.
(D) The company is in the Pioneering stage, and the operating risk associated with this stage is immensely high.

May/June 2023

16. According to the broad classification of obligor credit risk, which of the following represents the central layer in the sources of business risk?
(A) Internal Risk
(B) External Risk
(C) Financial Risk
(D) Industry Risk

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Oct/Nov 2010

17. Read the following assertion and reason, and select the correct option:
Assertion (A): The manner in which the government decides to raise resources and spend has significant business risk implications.
Reason (R): Augmenting resources is essential to minimize the fiscal deficit, and any resulting deficit has to be financed with the help of government borrowings.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2007

18. Identify the correct statement regarding firms categorised under "Medium Operating Risk and Medium Financial Risk".
(A) This represents average risk where firm size is near the industry mean, and solvency and liquidity are satisfactory.
(B) The finance function is ignored, and the balance sheet is overloaded with external debt and negligible owner support.
(C) Management is weak or dishonest, requiring continual attention from the lender, and some credit loss is unavoidable.
(D) These firms enjoy a dominant market position with low operating risks and hard negotiation power for interest rates.

Oct/Nov 2025

19. In the context of credit risk analysis, what is the most likely consequence of higher levels of inflation in an economy?
(A) It will persuade the central bank to decrease interest rates, which will boost the profitability of a business relying on leverage.
(B) It will render domestic goods highly competitive in international markets, leading to higher exports.
(C) It will cause a sharp drop in general price levels, translating into deflationary losses for manufacturing businesses.
(D) It will persuade the central bank to increase interest rates, which will sharply eat into the profitability of a business relying on leverage.

May/June 2012

20. Which of the following is NOT an indicator typically associated with an economy experiencing a recession?
(A) Profit rising faster than wages due to a rapid increase in productivity.
(B) A sustained period of negative growth in real GDP.
(C) A significant rise in the unemployment rate.
(D) Unusually high number of households and businesses unable to pay back loans.

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Oct/Nov 2014

21. How is a "cyclical industry" defined in the context of industry risk analysis?
(A) An industry that is completely immune to the macroeconomic indicators of the country.
(B) An industry that generates its highest profits exclusively during the pioneering stage.
(C) An industry that moves in tandem with business cycles, such as the construction and chemical industries.
(D) An industry whose product demand remains perfectly static regardless of economic fluctuations.

May/June 2019

22. Which of the following best describes the characteristics of a firm operating with Low Operating Risk and High Financial Risk?
(A) The firm enjoys stable market conditions and good management, along with excellent debt service capacity and a highly satisfactory liquidity position.
(B) The firm faces weak financial performance and high costs, but low operating risks allow for potential migration to a better class.
(C) The firm has uncertain business prospects due to external factors but maintains a highly satisfactory financial position with negligible external debt.
(D) The firm experiences weak management, murky external environments, and

impaired capacity to repay credit, making it unviable for lending.

Oct/Nov 2009

23. Arrange the following phases of a business cycle in the correct chronological sequence, starting from the phase of weak or negative growth:

I Recovery
II Trough
III Peak
IV Recession

Which of the following represents the correct sequence?

(A) (IV), (II), (I), (III)
(B) (IV), (I), (II), (III)
(C) (II), (IV), (I), (III)
(D) (I), (III), (IV), (II)

May/June 2016

24. Identify the correctly matched pair regarding government policy tools and their primary functions.

(A) Fiscal Policy – Attempting to control money supply through the buying and selling of treasury securities.
(B) Monetary Policy – Utilizing surcharges, disinvestments, and tariffs to raise government revenue.
(C) Enterprise Risk Management (ERM) – Regulating the flow of credit and setting interest rates in the domestic market.
(D) Fiscal Policy – Acting as a countercyclical measure through routine and planned/ unplanned government spending.

Oct/Nov 2024

25. Evaluate the following statements regarding the study of National Income (NI) components and their link to credit risks:

I Improving consumption under economic growth triggers demand for intermediate and basic components.
II During an economic recession, spending touches lower levels, leading to the collapse of weak businesses.
III The agriculture sector usually has a faster growth rate compared to services, trade, and industry.
IV Additional investments driven by strong business confidence stimulate demand for finance and creation of new assets.

Which combination of statements is correct?

(A) (I), (II) and (III)
(B) (I), (II) and (IV)
(C) (II), (III) and (IV)
(D) (I), (III) and (IV)

May/June 2010

26. Analyze the following business scenario to answer the question: Alpha Manufacturing Ltd is currently experiencing severe raw material shortages due to new import restrictions imposed by the government, impacting its production schedules. Additionally, the company has recently taken a significant amount of high-interest short-term debt to fund its working capital, straining its cash flows. As a credit analyst assessing the obligor risk, how should you categorise these events?

(A) The import restrictions represent internal risks, while the high-interest debt represents business-specific operational risks.
(B) The import restrictions represent industry-level risks, while the high-interest debt represents daily operational risks.
(C) Both events are classified exclusively under financial risks as they ultimately impact the long-term balance sheet stability.
(D) The import restrictions represent external business risks, while the high-interest debt represents financial risks.

Oct/Nov 2005

27. Arrange the following stages of the industry life cycle in their correct chronological order:

I Decline (and Death)
II Rapid Growth Stage
III Stabilization
IV Maturity growth
V Pioneering Stage

Which of the following represents the correct sequence?

(A) (V), (II), (IV), (III), (I)
(B) (V), (IV), (II), (III), (I)
(C) (V), (III), (II), (IV), (I)
(D) (II), (V), (IV), (III), (I)

May/June 2020

28. Read the following assertion and reason, and select the correct option:

Assertion (A): Banks often chase firms categorized under "Low Operating Risk and

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Low Financial Risk", resulting in narrowed profit margins for the lenders.
Reason (R): These firms enjoy a dominant market position, satisfactory liquidity, and excellent debt service capacity, making them hard negotiators for fine-tuning interest rates.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2021

29. Evaluate the following economic scenario: A major global economy is experiencing a scenario where demand has severely slowed down, leading to a continuous drop in price levels. Businesses are facing losses, resulting in shutdowns and rising unemployment, which further depresses demand. If a local exporting firm relies heavily on this global economy for its revenues, how should its obligor risk be assessed?
(A) The firm's credit risk is low because falling prices will decrease its cost of raw materials proportionally.
(B) The firm faces significant external risk due to deflationary pressures in its target market impacting export sales.
(C) The firm is insulated from external risk because deflation is primarily a symptom of high production efficiency.
(D) The firm's risk rating should be upgraded as the central bank of the importing country will adjust interest rates.

May/June 2013

30. Consider the following statements regarding the business cycle and its impact on obligor risks:
I During a trough, unemployment levels are high, production levels are at their lowest, and there is a general sense of gloom in the economy.
II In the first half of an economic expansion, it appears that wages rise much faster than profits due to decreasing productivity.
III At the peak of the business cycle, euphoric conditions prevail, and over-confident investments are often undertaken, creating over-capacity.
Which combination of statements is correct?
(A) (I) and (II)
(B) (II) and (III)
(C) (I) and (III)
(D) (I), (II) and (III)

Oct/Nov 2008

31. Which of the following areas need to be looked into for analyzing management risk within a firm?
I Imbalance in top management and concentration of power in few people.
II Weak control on finance and lack of internal control.
III Too ambitious projects and poor corporate governance.
IV Cyclicality of industries and government support priorities.
Which combination of statements is correct?
(A) (I), (II) and (III)
(B) (I), (II) and (IV)
(C) (II), (III) and (IV)
(D) (I), (III) and (IV)

May/June 2006

32. Analyze the following comparison: HeavyMetal Industries is a capital-intensive manufacturing firm with a Gearing Ratio of 2.5. SafeConsulting is a purely service-oriented IT firm with a Gearing Ratio of 0.8. A sudden recession hits the economy, severely compressing profit margins for both firms. How should a credit analyst evaluate the relative vulnerability of these two firms?
(A) SafeConsulting is more vulnerable because service industries require higher gearing to survive recessions.
(B) HeavyMetal Industries is more vulnerable because highly geared companies face a rigid, disproportionately heavy interest burden as profits decline.
(C) Both firms are equally vulnerable because the Gearing Ratio has no bearing on financial risk during a recession.
(D) HeavyMetal Industries is less vulnerable because its high gearing indicates it has

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tapped maximum external sources to build a massive cash buffer.

Oct/Nov 2017

33. Which of the following are considered factors that determine the intensity of industry competition and risk according to the Five Forces model?

I Number of Rivals
II Differentiation
III Exit Barriers
IV Threat of New Entrants
V Enterprise Risk Management (ERM)

Which combination of statements is correct?

(A) (I), (II), (III) and (IV)
(B) (I), (II), (IV) and (V)
(C) (II), (III), (IV) and (V)
(D) (I), (III), (IV) and (V)

May/June 2018

34. The Sales Growth ratio provides the direction in which the business has moved. Consider the following areas that may be impacted or alerted by this ratio:

I The firm's profits
II The firm's cash needs
III Internal cash generation capacity
IV Reasons for growth, decline, and stagnancy in business
V Adequacy of business strategies when compared with the industry

Which combination of statements is correct?

(A) (I), (II), (III) and (IV)
(B) (I), (III), (IV) and (V)
(C) (II), (III), (IV) and (V)
(D) (I), (II), (III), (IV) and (V)

Oct/Nov 2016

35. Consider the business model described below: SuperMart Retail is a cash-based business that buys goods on a 60-day credit period from its suppliers but sells its inventory entirely on a cash basis within 15 days. Consequently, its Current Ratio is calculated at 0.85:1. How should a credit analyst evaluate this ratio?

(A) A low ratio here does not imply liquidity problems, as favorable credit terms cover the operating cycle.
(B) The ratio is critically low; SuperMart must be denied credit because any ratio below 1.0 implies bankruptcy.
(C) The ratio indicates that SuperMart has an excessive amount of slow-moving inventory needing liquidation.
(D) The credit analyst must add fixed assets to current assets to raise the ratio above the 1.50:1 norm.

May/June 2025

36. Consider the comparison between two different industries: MegaMart is a food and provisions retailer operating on a low price/high volume strategy. TechMakers is a typical manufacturing business. How should a credit analyst compare the Operating Profit Margin (OPM) of these two entities?

(A) TechMakers has a higher OPM, while MegaMart operates on a lower OPM due to high volume returns.
(B) MegaMart will likely have a higher OPM than TechMakers because food retail requires high expenses.
(C) Both will have an identical OPM as long as their Gross Profit Margins are the same for the period.
(D) MegaMart will have a negative OPM due to perishability, whereas TechMakers relies on Net Margin.

Oct/Nov 2013

37. Read the following case and answer the question: Delta Airlines operates in a highly competitive market where multiple new budget airlines have recently entered. Passengers now have high bargaining power, and the threat of substitute transport modes (like high-speed rail) is increasing. Based on Prof. Michael Porter's Five Forces Model, how should a credit analyst interpret these developments for Delta Airlines?

(A) High threat of entrants, substitutes, and buyer power will likely squeeze margins and increase credit risk.
(B) The intensity of competition will decrease, leading to an automatic increase in the industry's overall profitability.
(C) The threat of new entrants will force Delta Airlines to move into the pioneering stage to cut fixed costs.
(D) The situation indicates that the factors of production are highly mobile, nullifying the competitive threats.

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May/June 2015

38. What is the primary conceptual risk associated with a highly geared company during an economic downturn?

(A) The company will be unable to issue dividend payouts, resulting in immediate regulatory action.

(B) High gearing restricts use of internal equity, forcing reliance on short-term current assets.

(C) Gearing ratios are inversely proportional to risk; higher gearing implies stronger resilience.

(D) Heavy interest and repayment commitments make highly geared firms more vulnerable to recessions.

Oct/Nov 2012

39. Read the following credit review scenario: During a credit review of AlphaCorp, you notice that its Dividend Payout Ratio for the past three years has consistently been 1.2:1. As a creditor assessing the obligor's financial risk, what does this trend indicate and how should you react?

(A) It indicates a healthy growing company retaining profits, requiring no intervention.

(B) It indicates that the firm's Retention Ratio is positive, ensuring a buffer against loss.

(C) It shows the firm is using leverage to minimize costs; therefore, credit should expand.

(D) It shows the firm is paying shareholders more than it earns, which is a serious concern.

May/June 2009

40. Why is it essential for the credit analyst or corporate management to understand the goals and objectives of a borrowing customer?

(A) Because it eliminates the need to conduct any financial ratio analysis on the borrower's historical data.

(B) Because objectives and goals are usually short-term and ensure that the borrower can bypass all risks.

(C) Because setting goals guarantees that the firm will successfully transition from the pioneering stage.

(D) Because comparing goals with performance clarifies related risks, mitigants, and strategy adequacy.

Oct/Nov 2020

41. Match the Return on Investment (ROI) Ratios with their respective formulas:

List I: Return on Investment (ROI) Ratios

P. Return on Assets (ROA)

Q. Return on Capital Employed (ROCE)

R. Return on Capital Employed (ROTCE)

S. Return on Equity (ROE)

List II: Formulas

1. Operating Profit / Average Operating Capital Employed
2. Net profit Available to Equity Shareholders / Equity Shareholder's Equity
3. PBIT / Average Total Cost
4. PBIT / AOCE (Average Overall Capital Employed)

(A) P-3, Q-1, R-4, S-2

(B) P-1, Q-3, R-2, S-4

(C) P-4, Q-2, R-1, S-3

(D) P-3, Q-4, R-1, S-2

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May/June 2022

42. It is often observed that firms operating in exactly the same external environment perform differently. What is the primary conceptual reason provided for this variance at the entity level?

(A) Uniform risk measurement ensures that all firms achieve the same profit margins across the sector.

(B) Variations only occur because of the differing geographical locations of the raw material suppliers.

(C) Internal risks like decision-making skills and competencies determine success regardless of environment.

(D) The differences are purely due to fluctuations in national income and foreign exchange rates.

Oct/Nov 2015

43. Which of the following financial ratio components is incorrectly paired with its formula?

(A) $\text{Quick Ratio} = \dfrac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$

(B) $\text{Interest Cash Cover} = \dfrac{\text{Interest paid}}{\text{Net cash from operation}}$

(C) $\text{Retention Ratio} = 1 - \text{Payout Ratio}$

(D) Debt Service Coverage Ratio

$= \dfrac{\text{Net profit after tax} + \text{Interest} + \text{Depreciation} + \text{Amortized}}{\text{Instalments} + \text{Interest}}$

May/June 2008

44. Consider the following statements regarding liquidity ratios:

I The Quick Ratio is calculated as:
$$\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

II The Cash Ratio includes inventory and accounts receivable in its numerator to provide a realistic measure of ability to pay obligations.

Which of the statements is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2023

45. An improving Gross Profit Ratio (GPR) is always welcome. Which of the following is NOT typically a reason for an improving GPR?

(A) Higher prices and increased production efficiency.
(B) Higher volume sufficient to bring in economies of scale.
(C) Strengthening of local currency resulting in lower value realization of exports.
(D) Change in stock valuation policy such that the closing inventory value is inflated.

May/June 2014

46. Which of the following statements correctly interprets the application of the Current Ratio in assessing financial risk?

(A) A Current Ratio below 1.50:1 automatically indicates an irreversible liquidity crisis, regardless of the industry.
(B) Seasonal fluctuations in working capital requirements should be ignored when assessing the Current Ratio.
(C) The higher the multiple of current assets to current liabilities, the greater the assurance that current liabilities will be paid.
(D) A low Current Ratio always means liquidity problems, even in cash-based businesses where higher credit terms are negotiated from suppliers.

Oct/Nov 2007

47. A low Fixed Assets Turnover Ratio signals under-utilization of fixed assets. Which of the following is NOT an appropriate adjustment or factor to consider when evaluating this ratio?

(A) An increasing trend usually indicates improving performance.
(B) Adding the value of utilized leased assets to the denominator results in a higher and artificially inflated ratio.
(C) Care should be taken if leased assets are present but not factored into the balance sheet.
(D) Leased assets utilized in the business depress the denominator if not factored in, resulting in a higher ratio.

May/June 2021

48. Match the risk assessment frameworks with their corresponding descriptive elements or functions:

List I: Risk Assessment Frameworks
P. Peer Group Analysis
Q. Entity Level Risk
R. Business Strategies
S. Management Analysis

List II: Descriptive Elements or Functions
1. Evaluates whether it is a one-man show, lack of skilled managers, and poor corporate governance.
2. Focuses on current capacities, level of business operations, and comparing strengths within the industry framework.
3. Studies the third category among business risks, acknowledging that firms in the same environment perform differently.
4. Aimed at attaining business objectives while minimizing risks, needing to be well-aligned to the SWOT analysis.

(A) P-3, Q-2, R-1, S-4
(B) P-2, Q-3, R-4, S-1
(C) P-4, Q-1, R-2, S-3
(D) P-1, Q-4, R-3, S-2

Oct/Nov 2019

49. Evaluate the following statements regarding the Debt Service Coverage Ratio (DSCR):

I The ratio measures the repayment ability of both the interest portion and also that of the instalments.

II Depreciation and amortized expenses are

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subtracted from the Net profit after tax in the numerator.

III The higher the DSCR, the better the repayment ability of the firm.

Which combination of statements is correct?

(A) (I) and (II)
(B) (I) and (III)
(C) (II) and (III)
(D) (I), (II) and (III)

May/June 2005

50. Read the following assertion and reason, and select the correct option:

Assertion (A): The Quick Ratio provides a more realistic measure of a firm's ability to pay current obligations from current assets than the Current Ratio, especially for firms carrying large inventories.

Reason (R): Inventories can hardly be liquidated at their book value on short notice, and the Quick Ratio excludes inventory to focus on highly liquid "quick assets".

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2022

51. Analyze the relationship between performance metrics in growth companies: When analyzing the Return on Capital Employed (ROTCE) for growth companies undergoing rapid expansion, what is the most appropriate interpretation of the gap between ROTCE and Cost of Funds (CF)?

(A) The gap should indefinitely remain negative because growth companies do not require external financing.
(B) Cost of Funds should constantly decline to zero to accommodate the low ROTCE of growth companies.
(C) A lowering ROTCE indicates the company will fail, and credit must be withdrawn by the lender immediately.
(D) ROTCE is lower initially due to investments, but the gap should narrow as ROTCE increases above CF.

May/June 2017

52. Consider the following credit appraisal finding: Epsilon Manufacturing has a robust external market and a favorable industry outlook. However, during a credit appraisal, the bank notes that Epsilon is essentially a "one man show", there is a severe concentration of power, a lack of skilled managers, and low staff morale. How should the bank view this exposure?

(A) Favorable industry outlook mitigates management issues, rendering the credit risk negligible for the bank.
(B) Internal financial control will naturally align with strategic goals, making it safe for long-term lending.
(C) Lack of skilled managers is a systematic risk and should be evaluated using macroeconomic indicators.
(D) Bad management represents high risk, as it can cause a good business to fail despite favorable conditions.

Oct/Nov 2011

53. Which of the following statements correctly interprets the application of the Current Ratio in assessing financial risk?

(A) A Current Ratio below 1.50:1 automatically indicates an irreversible liquidity crisis, regardless of the industry.
(B) Seasonal fluctuations in working capital requirements should be ignored when assessing the Current Ratio.
(C) The higher the multiple of current assets to current liabilities, the greater the assurance that current liabilities will be paid.
(D) A low Current Ratio always means liquidity problems, even in cash-based businesses where higher credit terms are negotiated from suppliers.

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May/June 2024

54. Consider the following statements regarding dividend and equity ratios:

I Retention Ratio is the reciprocal of the Dividend Payout Ratio, calculated as (1 - Payout Ratio).

II If retained profit is utilized to reduce

current liabilities, it generally leads to an improvement in solvency and liquidity ratios.

Which of the statements is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2006

55. Match the financial ratios with their corresponding formulas:

List I: Financial Ratios

P. Gearing Ratio
Q. Debt Equity Ratio
R. Interest Coverage Ratio
S. Payout Ratio

List II: Formulas

1. Total outside liabilities / (TNW + Non Redeemable preferential share)
2. Interest Bearing Debt / (Net Worth + Non-Redeemable Preferential share)
3. Dividends / Profit after tax
4. Profit Before Interest and Tax (PBIT) / Finance costs

(A) P-1, Q-2, R-3, S-4
(B) P-1, Q-2, R-4, S-3
(C) P-4, Q-3, R-2, S-1
(D) P-2, Q-4, R-1, S-3

May/June 2011

56. While deciding the peer group for Peer Group Analysis, considerations need to be given to several parameters to understand how the credit risk profile compares with the rest of the industry. Which of the following is generally NOT explicitly mentioned as a key parameter for this consideration?

(A) Personal net worth of the mid-level managers
(B) Revenue/sales
(C) Number of employees
(D) Market capitalization

Oct/Nov 2018

57. Identify the correctly paired operational or profitability ratio formula.

(A) Fixed Assets Turnover Ratio $= \dfrac{\text{Net Sales}}{\text{Fixed Assets}}$

(B) Sales Growth $= \dfrac{\text{Current year sales} - \text{Last year sales}}{\text{Current year sales}} \times 100$

(C) Gross Profit Ratio $= \dfrac{\text{Net Sales}}{\text{Gross Profit}} \times 100$

(D) Operating Profit Ratio $= \dfrac{\text{Net Profit}}{\text{Net Sales}} \times 100$

May/June 2023

58. What does the concept of "Buffer against losses" indicate when evaluating the Current Ratio of a borrower?

(A) It represents the margin of safety available to cover shrinkage in noncash current asset values when ultimately disposing of or liquidating them.
(B) It measures the firm's ability to pay dividends to equity shareholders out of current liabilities.
(C) It indicates the percentage by which a firm's current liabilities can shrink before becoming less than the amount needed to cover net working capital.
(D) It reflects the absolute value of cash and marketable securities held by the central bank.

Oct/Nov 2010

59. Traditionally, what is considered a satisfactory level for the Interest Coverage Ratio to reflect that a business generates enough profit to meet its interest service obligations?

(A) Above 0.50x
(B) Above 1.00x
(C) Above 1.50x
(D) Above 2.50x

May/June 2007

60. Which of the following formulas correctly represents the "Net working capital to current assets" ratio?

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(A) $\dfrac{\text{Total Current Assets} - \text{Total Current Liabilities}}{\text{Current Liabilities}}$

(B) $\dfrac{\text{Networking Capital}}{\text{Current Assets}}$

(C) $\dfrac{\text{Total Current Liabilities}}{\text{Networking Capital}}$

(D) $\dfrac{\text{Cash} + \text{Marketable Securities}}{\text{Networking Capital}}$

Oct/Nov 2025

61. Read the following business assessment: Horizon Textiles has displayed a continuous decline in its Current Ratio (now at 0.70:1) and an increasing Debt-to-Equity ratio. A management analysis reveals deep disharmony

in management, a myopic vision, and weak control over finance. Despite the industry being in the Rapid Growth stage, Horizon is struggling. What is the most accurate credit risk assessment for Horizon Textiles?

(A) Rapid Growth in the industry will automatically rectify management disharmony and restore liquidity.
(B) Because Horizon operates in a growing industry, liquidity ratios should be disregarded by the lender.
(C) Internal risks like bad management overshadow the favorable environment, indicating very high credit risk.
(D) The combination of declining liquidity and rising leverage proves Horizon has a cost leadership strategy.

May/June 2012

62. Read the following assertion and reason, and select the correct option:
Assertion (A): A falling Trade Creditors Payment Period ratio may indicate that the company is becoming more liquid and less reliant on creditors.
Reason (R): It may also indicate poor working capital management where creditors are shortening or even cancelling credit to the firm.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2014

63. Evaluate the following observation: During the annual review of an obligor, you observe that the Debtors Collection Period has been consistently decreasing over the last three years. The total sales have remained stable. As a credit analyst, what is the most logical deduction regarding this trend?

(A) The decreasing ratio is a matter of concern as it signals an impending accumulation of bad debts.
(B) The firm might be shifting its sales policy from Letters of Credit (LC) terms to completely clean sales.
(C) The trend indicates improvement in collection efficiency, likely driven by tighter credit terms.
(D) The trend confirms that the company is experiencing a liquidity crisis and is holding excess inventory.

May/June 2019

64. What is the most appropriate primary objective of conducting Peer Group Analysis within the industry risk analysis framework?

(A) To evaluate whether the macroeconomic business cycle is in a trough or a recovery phase.
(B) To compute the exact net national income of the country based on consumption and investment.
(C) To identify superior companies by comparing strengths and strategies against competitors in the industry.
(D) To dictate the monetary policy tools that the central bank should deploy to control inflation.

Oct/Nov 2009

65. Identify the incorrect statement regarding the "Fixed Assets to Total Assets Ratio".

(A) Higher ratios highlight the significance of fixed assets for the business and indicate its capital-intensive nature.
(B) An increasingly higher ratio over successive periods always indicates that the fixed assets are becoming fully depreciated and need urgent replacement.
(C) Manufacturing and real estate businesses typically have a high ratio, whereas service industries generally have a low ratio.
(D) A falling ratio may indicate fixed assets getting older as they become depreciated, suggesting the need for maintenance or replacement.

May/June 2016

66. What does a negative "Working Capital to Sales Ratio" generally indicate for a cash-based business?

(A) It highlights severe over-trading where an under-capitalized firm seeks rapid sales growth.

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(B) It demonstrates that the business is facing tight liquidity and is forced to extend credit.
(C) It proves that the fixed assets of the firm are heavily depreciated and need replacement.
(D) It indicates supplier credit exceeds the stocking period while sales are made primarily on cash.

Oct/Nov 2024

67. Systemic risks originating from the macro economy broadly influence the success of a country's credit market. Which of the following is NOT classified as a primary source of external risk affecting an obligor?
(A) Changes in the business cycle such as recession and recovery.
(B) Volatility in foreign currency rates resulting from balance of payments deficits.
(C) Monetary policy shifts including changes in interest rates by the central bank.
(D) The intensity of bargaining power of suppliers within a specific localized market.

May/June 2010

68. Analyze the following business environment: Omega Corp operates in a cyclical industry currently in its "Stabilization" life cycle phase. The broader macro economy has just entered a "Recession". Omega has a high degree of operating leverage but currently maintains strong liquidity buffers. How should a bank manage its credit exposure to Omega during this period?
(A) Cyclicality in recession implies declining profits, but Omega's liquidity requires monitoring over avoidance.
(B) The bank should forcibly liquidate Omega's assets, as industries in stabilization cannot survive recessions.
(C) The bank must recognize that portfolio risk will peak during the top of the business cycle, lowering risk now.
(D) Omega should be advised to undertake capacity expansion to take advantage of depressed asset prices today.

Oct/Nov 2005

69. A decrease in the Working Capital to Total Assets Ratio will occur due to certain specific reasons. Consider the following factors:
I Higher reliance on suppliers' credit.
II An increase in fixed assets.
III Improved stock management.
IV Sale and lease back of fixed assets.
Which combination of statements is correct?
(A) (I), (II) and (IV)
(B) (I), (II) and (III)
(C) (II), (III) and (IV)
(D) (I), (III) and (IV)

May/June 2020

70. In credit and financial parlance, how is the gradual decline or improvement in the creditworthiness of a borrower or obligor conceptually termed?
(A) Credit enhancement
(B) Credit migration
(C) Countercyclical maneuvering
(D) Technical recession

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ANSWERS

1. (D) The firm has uncertain business prospects, but its strong financial position may enable it to survive the cyclical downturn.
A borrower with high operating risk but low financial risk possesses a strong capital structure that acts as a cushion during economic downturns. While the cyclical nature of the industry creates uncertainty regarding future sales and cash flows, minimal external debt and substantial cash reserves provide the necessary liquidity to withstand temporary recessionary pressures and survive the business cycle.

2. (C) Current Account – Purchase/sale of assets, loan/gold transactions, and foreign investments
The current account primarily records a nation's transactions involving the export and import of goods and services, alongside income transfers like dividends and interest. In contrast, the purchase and sale of assets, foreign investments, and loan transactions are components of the capital account. Mistakenly attributing asset-based transactions to the current account represents a fundamental macroeconomic misclassification in risk analysis.

3. (A) Only (I)
Credit risk assessment involves evaluating the intersection of operational stability and financial health. A firm exhibiting low operating risk coupled with medium financial risk typically maintains sufficient stability to be classified as having low credit risk. However, combining medium operating risk with high financial risk generally leads to a high credit risk classification rather than the very high risk category.

4. (A) (I) and (II)
Industry risk stems from external macroeconomic factors and specific competitive dynamics. Government policy changes, such as adjustments to import duties or corporate taxes, represent significant external pressures. Industry-specific risks include the bargaining power of buyers and suppliers and competitive entry. Conversely, industry drivers are often influenced by broader market demand patterns rather than being dependent exclusively on internal management.

5. (B) Two consecutive quarters of negative growth in real GDP.
A technical recession is specifically defined in economic terms as a period marked by two consecutive quarters of negative growth in real Gross Domestic Product. This metric provides a standardized way for media and analysts to identify a significant contraction in economic activity. It distinguishes a formal downturn from temporary fluctuations or a single quarter of poor performance.

6. (B) P-2, Q-4, R-3, S-1
The industry life cycle progresses through distinct phases defined by growth rates and competitive intensity. Rapid growth involves increasing profits with limited competition. Maturity follows as demand slows and new entrants erode margins. Stabilization occurs when growth mirrors the broader economy. Finally, the decline stage is characterized by negative growth and the emergence of superior and more efficient product substitutes.

7. (B) Business or operating risks
Credit events of a non-financial nature encompass the various operational challenges that threaten a company's ability to meet its strategic objectives. These are collectively categorized as business or operating risks. Such risks arise from internal process failures, management decisions, or external market shifts that disrupt the core activities of the enterprise, ultimately impacting its overall creditworthiness and long-term stability.

8. (B) $Y = C + I + G + (X - M)$
Gross Domestic Product or National Income is mathematically represented by an equation that aggregates total domestic expenditure and net foreign trade. This formula combines private consumption, gross investment, and government spending with the net balance of

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exports minus imports. This comprehensive calculation reflects the total economic output and income generated within a specific country during a given annual timeframe.

9. (B) (I), (III) and (IV)
The balance of payments tracks all financial interactions between a country and the global market. The current account specifically includes trade in goods, services, and unilateral transfers like gifts or employee compensation. To manage a current account deficit effectively, a nation must focus on increasing foreign exchange inflows. These components are essential for maintaining macroeconomic stability and exchange rates.

10. (C) A decline in the creditworthiness of a borrower is an abrupt and instantaneous process and is never a gradual migration from a low-risk asset to a higher risk level.
Credit risk deterioration is typically a gradual process referred to as credit migration, where a borrower's financial health slowly shifts from low-risk to higher-risk categories. It is rarely an instantaneous or abrupt event. Recognizing this progression allows lenders to monitor warning signs and implement mitigation strategies before a default occurs. Stable market conditions and strong management characterize high-quality firms.

11. (D) Money, Man, Machines, Material, and Management
The classic framework for factors of production is often summarized by the five essential resources required for business operations. These include money for capital, man for labor, machines for technology and equipment, material for raw inputs, and management for organizational oversight. Collectively, these elements determine the operational efficiency and productive capacity of an enterprise within its specific industry context.

12. (C) P-3, Q-1, R-4, S-2
Credit risk classifications are determined by the interaction between operational and financial risk profiles. A firm with low operational but high financial risk is generally considered medium-high risk. Medium operational and low financial risk results in a low credit risk rating. High operational risk combined with medium or high financial risk leads to high or very high risk assessments.

13. (A) Only (I)
A rising National Income during an economic expansion phase typically leads to increased consumer spending on both durable and non-durable goods. This surge in demand directly benefits manufacturing firms by driving higher sales volumes and improving profit margins. For a credit analyst, such macroeconomic growth indicates a favorable environment for the borrower, reducing credit risk and supporting business expansion.

14. (C) The investments will likely lead to increased sales and profits, provided over-capacity is avoided.
Transitioning from an economic recovery to a peak phase is characterized by high consumer confidence and peak production levels. Businesses that expand their capacity and inventory during this period are well-positioned to capture increased market demand. Such strategic investments typically lead to enhanced profitability and sales growth, provided the company manages its resources efficiently and avoids creating excessive over-capacity.

15. (D) The company is in the Pioneering stage, and the operating risk associated with this stage is immensely high.
In the pioneering stage of the industry life cycle, companies operate in small, unproven markets with significant uncertainties. Business owners must focus heavily on educating prospective customers, which often results in high initial costs and doubtful profitability. Because sales are low and the business model is still being tested, the operating risk associated with this stage is exceptionally high.

16. (A) Internal Risk
Business risk is conceptualized in layers, with internal risk forming the central core of this classification. While external and industry-level factors provide the broader context, internal risks relate specifically to the entity's management competencies, operational processes, and decision-making skills. These internal factors often determine why firms in

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understanding of credit risk than analyzing the company in isolation from market trends.

65. (B) An increasingly higher ratio over successive periods always indicates that the fixed assets are becoming fully depreciated and need urgent replacement.
The fixed assets to total assets ratio indicates the capital-intensive nature of a business. A falling ratio often suggests that assets are aging and becoming depreciated, which might signal a future need for significant maintenance or capital expenditure. However, an increasing ratio typically points to new investments in infrastructure rather than the presence of fully depreciated assets that require urgent and immediate replacement.

66. (D) It indicates supplier credit exceeds the stocking period while sales are made primarily on cash.
A negative working capital to sales ratio in a cash-based business typically indicates that the company is effectively utilizing supplier credit to fund its operations. This occurs when the credit period provided by suppliers is longer than the time it takes for the business to sell its inventory for cash. This situation reflects a strong bargaining position and efficient cash cycle management.

67. (D) The intensity of bargaining power of suppliers within a specific localized market.
External risks are systemic factors that originate from the macro economy and influence all businesses. These include business cycle fluctuations, foreign exchange volatility, and changes in central bank monetary policy. In contrast, the bargaining power of suppliers is an industry-specific risk that depends on the competitive dynamics within a particular market rather than broad macroeconomic shifts or government-level policy changes.

68. (A) Cyclicality in recession implies declining profits, but Omega's liquidity requires monitoring over avoidance.
Omega Corp faces significant challenges due to its high operating leverage and the onset of an economic recession in a cyclical industry. While these factors increase the risk of declining profits, the company's strong liquidity buffers provide a necessary cushion for survival. Lenders should closely monitor the situation rather than immediately avoiding the credit exposure, focusing on the firm's cash management and resilience.

69. (B) (I), (II) and (III)
A decrease in the working capital to total assets ratio can occur for several operational reasons. Increased reliance on supplier credit raises current liabilities, while improved stock management reduces current assets, both of which lower net working capital. Additionally, an increase in fixed assets grows the total asset base, resulting in a lower ratio if net working capital remains relatively constant over time.

70. (B) Credit migration
Credit migration is the term used to describe the gradual shift in a borrower's credit quality over time. Instead of being an abrupt event, the transition from a low-risk category to a higher-risk category—or vice versa—usually happens slowly as financial and operational conditions change. Monitoring these migrations allows lenders to manage portfolio risk effectively and adjust their credit strategies as needed.

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focuses on controlling the money supply and interest rates through central bank actions.

25. (B) (I), (II) and (IV)
National Income components provide critical insights into credit risk. Economic growth driven by rising consumption increases demand for basic components and raw materials. Conversely, recessions lead to lower spending levels that can cause weaker businesses to fail. Strong business confidence encourages additional investments, which in turn stimulates the demand for financial services and the creation of new assets.

26. (D) The import restrictions represent external business risks, while the high-interest debt represents financial risks.
Obligor risk assessment involves distinguishing between different types of challenges. Government-imposed import restrictions are classified as external business risks because they originate from outside the firm and impact its operations. High-interest short-term debt represents financial risk, as it relates to the company's capital structure and its ability to manage cash flows and meet its various debt obligations.

27. (A) (V), (II), (IV), (III), (I)
The industry life cycle begins with the pioneering stage, where new products are introduced to small markets. This is followed by rapid growth as demand expands. The industry then transitions into maturity growth, followed by stabilization, where growth aligns with the broader economy. Finally, the cycle ends with the decline stage as substitutes emerge and sales growth turns negative.

28. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Lenders often face narrowed profit margins when dealing with high-quality firms that possess low operating and financial risks. These borrowers enjoy dominant market positions and excellent debt service capacity, providing them with significant leverage to negotiate favorable interest rates. Because many banks compete for such low-risk assets, the resulting price competition naturally compresses the lender's potential returns.

29. (B) The firm faces significant external risk due to deflationary pressures in its target market impacting export sales.
Deflationary pressures in a major global economy can severely impact exporting firms by depressing demand and lowering price levels in target markets. Such conditions create significant external risks for the exporter, as declining revenues and market instability can threaten its financial viability. Credit analysts must recognize these macroeconomic dependencies when evaluating the overall risk profile of an internationally focused business.

30. (C) (I) and (III)
The business cycle includes a trough phase characterized by high unemployment, low production, and general economic pessimism. As the cycle reaches its peak, euphoric conditions often lead to over-confident investment decisions and the creation of industrial over-capacity. These fluctuations are critical for assessing credit risk, as they influence the timing of potential defaults and the overall health of borrowers.

31. (A) (I), (II) and (III)
Management risk analysis focuses on the internal leadership and governance of a firm. Key areas of concern include a lack of internal controls, an imbalance in top management, or a concentration of power in a few individuals. Furthermore, pursuing overly ambitious projects and maintaining poor corporate governance standards are critical indicators of high management risk that can jeopardize a company's stability.

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32. (B) HeavyMetal Industries is more vulnerable because highly geared companies face a rigid, disproportionately heavy interest burden as profits decline.
Firms with high gearing ratios are significantly more vulnerable during economic recessions. As profit margins compress due to declining demand, the rigid and heavy interest burden associated with high debt levels becomes difficult to service. In contrast, firms with lower gearing have greater financial flexibility and

Oct/Nov 2018

7. What represents an assessment of an entity's ability to pay its financial obligations?
(A) Liquidity scoring
(B) Credit rating
(C) Capital evaluation
(D) Provisioning benchmark

May/June 2010

8. Consider the following statements regarding the features of a bank's internal credit rating framework:
I All credit exposures should be rated.
II The grades used should represent without ambiguity the default risks associated with an exposure.
III No single credit risk rating system is ideal for any bank; it must be customized.
IV The responsibilities of final approval and monitoring can be merged with relationship management to save costs.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2005

9. Identify the correct pair connecting the sub-component to its corresponding key parameter under Financial Risk:
(A) Debt to Tangible Assets - Solvency Ratio
(B) Interest Coverage Ratio - Solvency Ratio
(C) Current Liquidity Ratio - Profitability
(D) Return on Assets - Leverage Analysis

May/June 2021

10. Consider the following statements regarding the benefits of a credit rating system:
I A properly designed credit scoring system allows creditors to evaluate thousands of applications consistently, impartially, and quickly.
II Incorrect pricing of taking credit risk can lead to risk/return imbalances, lost business, and adverse selection.
III The rating scale cannot be used to decide on the frequency or intensity of monitoring of an exposure.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2015

11. A borrower achieves a weighted credit score of 55%. According to the rating assignment scale, what is the corresponding rating description for this score?
(A) Moderate risk level
(B) Acceptable risk level
(C) Risk requires attention
(D) High risk level

May/June 2008

12. Which of the following is an incorrect statement regarding the usefulness of a rating system for credit approval and underwriting?
(A) Risk ratings are used to determine whether a particular credit proposal will be entertained or not.
(B) The bank's lending policy specifies the minimum rating of a borrower that will be acceptable at the entry point.
(C) By prescribing a maximum threshold rating grade, a bank ensures all high-risk exposures are automatically approved.
(D) Banks utilize a rating scale to define acceptable and unacceptable credit risk categories.

Oct/Nov 2009

13. The senior management of a bank wants to steer the organization from an initial low-risk low-return phase to consolidation, and further to an incremental rise in relatively high-risk high-return exposures. What component of the internal credit rating framework should they utilize to review the frequency distribution of assets and anticipated developments in the aggregated portfolio?
(A) The internal MIS requirements linked to the Credit Risk Framework
(B) Interaction with External Credit Assessment Institutions
(C) The conventional relationship management module
(D) The Red Herring prospectus of the borrowers

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and the entity's ability to navigate industry challenges and maintain financial stability.

41. (D) P-3, Q-4, R-1, S-2
Return on Investment ratios measure how efficiently a company uses its resources to generate profit. Return on Equity focuses on the net profit available to shareholders, while Return on Capital Employed compares earnings before interest and taxes to the total capital used. These metrics, including Return on Assets and Return on Operating Capital, provide critical insights into management's effectiveness and operational efficiency.

42. (C) Internal risks like decision-making skills and competencies determine success regardless of environment.
Firms operating within the same external and industry environment often achieve different levels of success due to internal factors. These include management's decision-making skills, operational competencies, and strategic choices. While external pressures affect all participants, the specific way a company manages its internal resources and risks determines its ultimate performance and resilience in a competitive marketplace.

43. (B) Interest Cash Cover

$$= \frac{\text{Interest paid}}{\text{Net cash from operation}}$$

Financial ratios must be calculated using specific formulas to provide accurate assessments of a firm's health. The interest cash cover ratio is intended to measure the ability to pay interest from operational cash flows. However, mistakenly reversing the numerator and denominator in this formula would lead to an incorrect interpretation of a company's debt-servicing capacity and overall financial stability.

44. (A) Only (I)
The quick ratio provides a measure of liquidity by excluding inventory from current assets, as inventory is often difficult to liquidate quickly. This ratio focuses on more liquid assets available to cover current liabilities. In contrast, the cash ratio is even more restrictive, typically including only cash and marketable securities, while excluding both inventory and accounts receivable from its calculation.

45. (C) Strengthening of local currency resulting in lower value realization of exports.
A strengthening local currency typically reduces the domestic value of export revenues, which can negatively impact a firm's gross profit ratio. Conversely, factors that improve this ratio include higher selling prices, increased production efficiency, and economies of scale. Additionally, changes in inventory valuation policies that inflate closing stock values can also lead to an artificial improvement in the reported gross profit.

46. (C) The higher the multiple of current assets to current liabilities, the greater the assurance that current liabilities will be paid.
The current ratio is a fundamental measure of a firm's ability to meet its short-term obligations. A higher multiple of current assets to current liabilities generally provides greater assurance that these debts will be paid on time. While industry norms vary, the ratio serves as an important indicator of the margin of safety available to cover potential shrinkage in asset values.

47. (B) Adding the value of utilized leased assets to the denominator results in a higher and artificially inflated ratio.
The fixed assets turnover ratio measures how efficiently a firm utilizes its long-term assets to generate sales. If a company uses leased assets that are not recorded on the balance sheet, the denominator is artificially low, leading to an overstated ratio. Properly accounting for these assets by adding their value to the denominator will result in a more accurate, lower ratio.

48. (B) P-2, Q-3, R-4, S-1
Risk assessment involves multiple frameworks to evaluate a borrower's profile. Peer group analysis compares a firm's strengths against industry competitors, while entity-level risk focuses on internal factors that lead to differing performance. Management analysis examines governance structures and leadership competencies. Finally, evaluating business strategies ensures that a firm's goals are well-

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the same industry environment experience different levels of success and financial stability.

17. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
Government decisions regarding resource allocation and spending significantly influence the business environment and overall economic risk. While it is true that fiscal deficits are often managed through government borrowings, this fact alone does not fully explain the complex relationship between public policy and specific business risks. Both statements are factually correct, but they lack a direct causal explanatory link.

18. (A) This represents average risk where firm size is near the industry mean, and solvency and liquidity are satisfactory.
Firms classified under the medium operating and medium financial risk category represent the industry average. These entities typically possess a market position close to the mean and maintain satisfactory levels of solvency and liquidity. While they do not enjoy the dominance of low-risk leaders, they also avoid the severe impairments associated with high-risk firms, presenting a balanced credit profile.

19. (D) It will persuade the central bank to increase interest rates, which will sharply eat into the profitability of a business relying on leverage.
High levels of inflation often prompt central banks to implement tighter monetary policies by increasing interest rates. For businesses that rely heavily on financial leverage, this increase in borrowing costs can sharply reduce profitability. Additionally, rising prices for inputs can squeeze margins if the company cannot pass these costs to consumers, further increasing the overall credit risk of the obligor.

20. (A) Profit rising faster than wages due to a rapid increase in productivity.
During an economic recession, typical indicators include negative GDP growth, rising unemployment, and a high frequency of loan defaults. Profits generally decline during this phase as consumer demand weakens. The scenario where profits rise faster than wages due to rapid productivity gains is actually a hallmark of the early expansion or recovery phase of the business cycle.

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21. (C) An industry that moves in tandem with business cycles, such as the construction and chemical industries.
A cyclical industry is one whose performance and demand patterns are closely correlated with the broader fluctuations of the business cycle. Industries such as construction, steel, and chemicals often experience significant growth during economic expansions and sharp declines during recessions. Understanding this relationship is crucial for credit analysts when evaluating the timing and volatility of a borrower's cash flows.

22. (B) The firm faces weak financial performance and high costs, but low operating risks allow for potential migration to a better class.
A firm characterized by low operating risk typically benefits from stable market conditions and competent management. However, high financial risk indicates weak financial performance, such as excessive debt or high interest costs. While the current financial position is strained, the underlying operational stability provides a foundation for the firm to potentially migrate toward a better credit risk classification.

23. (A) (IV), (II), (I), (III)
The business cycle follows a predictable chronological sequence of economic activity. It begins with a recession, which is a period of contraction, leading to the trough, the lowest point of economic activity. Following the trough, the economy enters the recovery phase as growth resumes, eventually culminating in the peak, which represents the highest level of production and expansion.

24. (D) Fiscal Policy – Acting as a countercyclical measure through routine and planned/ unplanned government spending.
Fiscal policy serves as a vital countercyclical tool that governments use to influence economic activity through routine and planned spending. By adjusting taxation and expenditure levels, the government can stimulate demand during downturns or cool an overheating economy. This differs from monetary policy, which primarily

Profitability and operational efficiency ratios must be calculated using accurate formulas to provide meaningful insights. The fixed assets turnover ratio is determined by dividing net sales by fixed assets, reflecting how well a company generates revenue from its long-term investments. Inaccurate formulas for sales growth or profit margins would lead to misleading conclusions about a firm's financial performance and operational health.

58. (A) It represents the margin of safety available to cover shrinkage in noncash current asset values when ultimately disposing of or liquidating them.
The concept of a "buffer against losses" in the context of the current ratio refers to the margin of safety that protects creditors. It represents the degree to which non-cash current assets, such as inventory and receivables, can decrease in value without jeopardizing the firm's ability to cover its current liabilities. This buffer is critical for assessing short-term creditworthiness and stability.

59. (C) Above 1.50x
The interest coverage ratio is a key indicator of a firm's financial health, showing how easily it can pay interest on its outstanding debt. Traditionally, a ratio above 1.50x is considered a satisfactory level, suggesting that the business generates sufficient earnings to meet its interest obligations. A lower ratio may signal potential distress and an inability to handle rising interest costs or declining profits.

60. (B) $\frac{\text{Networking Capital}}{\text{Current Assets}}$
The ratio of net working capital to current assets provides insight into the proportion of a firm's current assets that are financed by long-term sources of funds. It is calculated by dividing net working capital by total current assets. This metric helps analysts understand the liquidity profile of a business and its reliance on short-term versus long-term financing for daily operations.

61. (C) Internal risks like bad management overshadow the favorable environment, indicating very high credit risk.
Horizon Textiles faces very high credit risk due to significant internal management issues, including disharmony and weak financial control. Even though the industry is in a rapid growth phase, these internal failures overshadow the favorable external environment. The combination of declining liquidity and increasing financial leverage further indicates a deteriorating credit profile that the industry's growth cannot automatically rectify.

62. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
A decline in the trade creditors payment period can be interpreted in multiple ways during financial analysis. It might suggest that the firm's liquidity position has improved, allowing it to pay suppliers more quickly. Alternatively, it could indicate that suppliers are losing confidence in the company and are demanding faster payments or tightening their credit terms. Both perspectives are valid interpretations.

63. (C) The trend indicates improvement in collection efficiency, likely driven by tighter credit terms.
A consistent decrease in the debtors collection period, while total sales remain stable, generally points toward an improvement in a company's collection efficiency. This trend suggests that the firm's management has implemented tighter credit terms or more effective follow-up procedures. For a credit analyst, this is a positive sign that enhances the company's liquidity and reduces the risk of bad debts.

64. (C) To identify superior companies by comparing strengths and strategies against competitors in the industry.
The primary goal of conducting peer group analysis is to evaluate a firm's relative performance within its industry. By comparing a company's financial metrics and strategic positioning against its competitors, analysts can identify superior entities and understand the borrower's competitive advantages. This comparative approach provides a more nuanced

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aligned with its strengths and the external environment.

49. (B) (I) and (III)
The debt service coverage ratio is a critical metric for evaluating a firm's ability to repay its long-term debt, including both interest and principal installments. A higher ratio indicates a stronger repayment capacity and lower credit risk. When calculating the numerator, non-cash expenses such as depreciation and amortization are added back to net profit to reflect the total cash available.

50. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The quick ratio offers a more conservative and realistic view of liquidity than the current ratio by excluding inventory from its numerator. This is based on the fact that inventories often cannot be liquidated at their full book value on short notice during a crisis. By focusing on highly liquid "quick assets," this ratio provides a clearer picture of immediate debt-paying ability.

51. (D) ROTCE is lower initially due to investments, but the gap should narrow as ROTCE increases above CF.
Rapidly expanding growth companies often experience an initial phase where the return on capital employed is lower than the cost of funds due to heavy investments. As the business matures and begins generating higher returns, this gap should narrow and eventually turn positive. Credit analysts monitor this trend to ensure the company's profitability will eventually exceed its financing costs.

52. (D) Bad management represents high risk, as it can cause a good business to fail despite favorable conditions.
Management quality is a decisive factor in business success, as even firms in favorable industries can fail due to poor leadership. A "one-man show" characterized by concentrated power and low staff morale represents significant internal risk. Lenders must view such management weaknesses as a serious threat to the borrower's stability, regardless of positive external market trends or industry outlooks.

53. (C) The higher the multiple of current assets to current liabilities, the greater the assurance that current liabilities will be paid.
The current ratio remains a primary tool for assessing a company's short-term financial stability. It indicates whether a firm has sufficient liquid assets to cover its upcoming liabilities. A higher ratio suggests a stronger cushion against potential financial shocks. Analysts must consider industry-specific factors and the quality of the current assets when interpreting this ratio to ensure a comprehensive risk assessment.

54. (C) Both (I) and (II)
The retention ratio represents the portion of net profit kept within a business rather than being paid out as dividends. It is the complement of the dividend payout ratio. When these retained profits are used to reduce current liabilities, the firm's solvency and liquidity ratios generally improve. This strengthening of the balance sheet provides a better buffer against potential future losses.

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55. (B) P-1, Q-2, R-4, S-3
Financial ratios like gearing and debt-equity provide essential insights into a company's capital structure and long-term solvency. The interest coverage ratio measures a firm's ability to pay interest expenses from its earnings before interest and taxes. Additionally, the dividend payout ratio shows the proportion of earnings distributed to shareholders. Together, these metrics help analysts evaluate financial leverage and risk.

56. (A) Personal net worth of the mid-level managers
Peer group analysis involves comparing a company's financial and operational performance against similar entities in the same industry. Key parameters for this comparison typically include total revenue, the number of employees, and market capitalization. Irrelevant data, such as the personal net worth of mid-level managers, is not used because it does not reflect the entity's competitive position or overall credit risk profile.

57. (A) $\text{Fixed Assets Turnover Ratio} = \dfrac{\text{Net Sales}}{\text{Fixed Assets}}$

CHAPTER 08
Credit Rating System

Oct/Nov 2014

1. Based on internal provisioning guidelines for credit risk, what action is most appropriate when an existing credit exposure moves to the "unacceptable" category of credit risk (grades 6 to 9)?
(A) Immediately write off the loan asset from the balance sheet.
(B) Direct the exposure to external credit assessment institutions for liquidation.
(C) Increase the tenure of the proposed assistance to reduce borrower burden.
(D) Identify the provisioning required for expected losses.

May/June 2007

2. Arrange the following steps involved in the process of assigning a risk rating to an exposure in the correct chronological order:
I Allocate weights to principal risk components
II Establish the key parameters (sub-components)
III Identify all the principal business and financial risk elements
IV Assign weights to each of the key parameters
(A) (I), (III), (II), (IV)
(B) (III), (I), (II), (IV)
(C) (III), (II), (I), (IV)
(D) (I), (II), (III), (IV)

Oct/Nov 2023

3. Which of the following best describes the nature of a credit rating regarding a borrower's creditworthiness?
(A) It provides a guaranteed prediction of historical default certainty.
(B) It provides a backward-looking audit of financial obligations.
(C) It provides a forward-looking assessment of relative creditworthiness.
(D) It provides absolute certainty regarding the future probability of default.

May/June 2019

4. Consider the following indicators utilized during a rating exercise:
I Whether in time
II Fulfilment of terms of sanction
III Whether there has been diversification of funds
IV Whether there has been devolvement of BG/LC etc
V Coverage by collaterals
Which combination of the above statements correctly represents the parameters categorized exclusively under "Conduct of Account"?
(A) (I), (II), (III), and (V)
(B) (II), (III), (IV), and (V)
(C) (I), (II), (III), and (IV)
(D) (I), (III), (IV), and (V)

Oct/Nov 2011

5. A bank recently sanctioned additional facilities to existing customers and onboarded several new corporate clients. The Chief Risk Officer wants to evaluate how these additions alter the overall absolute risk and incremental risk of the bank. Which tool should the bank primarily rely on to assess this consequential change?
(A) The Red Herring prospectus
(B) The Credit Risk Rating (CRR) system
(C) The statutory audit report of the new clients
(D) The Basel II capital adequacy minimum requirements

May/June 2024

6. A commercial client exhibits a Debt Service Coverage Ratio (DSCR) of 2.10. Based on a standard financial scoring scale where a ratio above 2.0 earns the maximum marks, what is the score obtained for this parameter?
(A) 5
(B) 3
(C) 1
(D) 0

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are better positioned to withstand a downturn without facing an immediate liquidity or solvency crisis.

33. (A) (I), (II), (III) and (IV)
The intensity of industry competition and associated risk are determined by several key factors within the Five Forces model. These include the number of rivals, the degree of product differentiation, the level of exit barriers, and the threat of new entrants. Collectively, these forces shape the profit potential of an industry and determine the competitive environment for all participants.

34. (D) (I), (II), (III), (IV) and (V)
The sales growth ratio is a versatile metric that reveals the direction of a business and alerts analysts to several critical areas. It impacts a firm's profitability, internal cash generation capacity, and immediate cash needs. Furthermore, it helps identify the underlying reasons for business fluctuations and assists in evaluating the adequacy of corporate strategies compared to broader industry trends.

35. (A) A low ratio here does not imply liquidity problems, as favorable credit terms cover the operating cycle.
A current ratio below 1.0 does not always indicate a liquidity crisis, particularly for cash-based retail businesses. Such firms often negotiate favorable credit terms with suppliers while selling inventory quickly for cash. This operational efficiency allows them to meet obligations despite having fewer current assets than current liabilities. In these cases, the low ratio reflects a specific and effective business model.

36. (A) TechMakers has a higher OPM, while MegaMart operates on a lower OPM due to high volume returns.
Operating Profit Margins vary significantly across different industries due to their unique business models. Food and provisions retailers typically operate on a high-volume, low-price strategy, resulting in lower OPMs. In contrast, manufacturing firms generally require higher margins to cover their significant fixed costs and capital investments. Analysts must use industry-specific benchmarks when evaluating these profitability metrics.

37. (A) High threat of entrants, substitutes, and buyer power will likely squeeze margins and increase credit risk.
Based on Porter's Five Forces Model, an increase in the number of competitors, passenger bargaining power, and substitute transport modes directly heightens industry risk. These factors collectively squeeze profit margins and increase the credit risk for established players. Such competitive pressures force firms to constantly innovate or reduce costs to maintain their market position and financial health in a changing industry.

38. (D) Heavy interest and repayment commitments make highly geared firms more vulnerable to recessions.
The primary risk associated with a highly geared company during an economic downturn is the rigid nature of its financial obligations. Heavy interest payments and principal repayments must be met regardless of declining sales or profits. This lack of financial flexibility makes highly geared firms more susceptible to default when cash flows are constrained by recessionary pressures in the broader economy.

39. (D) It shows the firm is paying shareholders more than it earns, which is a serious concern.
A dividend payout ratio exceeding 1.0 indicates that a firm is distributing more money to its shareholders than it is currently earning in net profit. This unsustainable practice depletes the company's internal reserves and may suggest it is using debt or asset sales to fund dividends. For a creditor, this trend is a serious concern that signals potential financial instability.

NODIA

40. (D) Because comparing goals with performance clarifies related risks, mitigants, and strategy adequacy.
Understanding a borrower's goals and objectives is essential for a comprehensive credit analysis. By comparing these goals with actual historical performance, an analyst can evaluate the adequacy of the firm's strategies and the effectiveness of its risk mitigants. This process clarifies the link between management's vision

May/June 2013

14. The following question consists of two statements — Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): The board of directors should approve the credit risk rating system and assign clear responsibility and accountability for the risk rating process.
Reason (R): The board should receive sufficient information to oversee management's implementation of the process.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2025

15. Based on a credit scoring scale for financial risk parameters, if a borrower has a Total Outside Liabilities to Tangible Net Worth (TOL/TNW) ratio of 3.50, what score should be assigned to this parameter? (Note: The scale assigns 3 marks for ratios between 3.0 and 4.0).
(A) 5
(B) 4
(C) 3
(D) 0

May/June 2005

16. Why is credit risk considered the most obvious and dominant risk in a bank?
(A) Because a major part of the assets in a bank's balance sheet are loan assets
(B) Because it is the only risk recognized by the international regulatory framework
(C) Because credit ratings are mandatory for every category of bank deposit account
(D) Because external rating agencies determine the bank's capital adequacy ratio

Oct/Nov 2010

17. Match the Financial Risk ratios in List I to their respective categories in List II as per a standard risk indicator model:
List I: (Ratio)
P. Quick Ratio
Q. DSCR
R. Debt Equity Ratio
S. Return on assets
List II: (Category)
1. Profitability Ratio
2. Solvency Ratio
3. Liquidity Ratio
4. Leverage Ratio
(A) P-3, Q-2, R-4, S-1
(B) P-4, Q-1, R-3, S-2
(C) P-2, Q-4, R-1, S-3
(D) P-1, Q-3, R-2, S-4

May/June 2022

18. Consider the following statements regarding bank credit risk:
I The admission of new customers alters the credit risk profile of the bank depending on the credit risk ratings awarded to them at the entry point.
II Tracking risk migration involves assessing the portfolio quality by tracking the movement of risk ratings assigned to borrowers over time.
Which of the above statement(s) is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2016

19. When classifying the risk indicators for a credit rating model, under which principal risk component are "Business cycle" and "Economic conditions" primarily grouped?
(A) Financial Risk components
(B) Management Capability traits
(C) Account Conduct history
(D) External Risk sub-components

May/June 2014

20. Identify the correct pair regarding the segregation of rating assignment and approval activities in conventional banks:
(A) Assigning the initial risk-ratings - Vested with conventional relationship staff
(B) Final approval and monitoring - Vested with the front-office staff
(C) Top management decision-making -

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May/June 2014

62. Match the rating concepts in List I with their defining focus areas in List II:

List I: (Concept)

P. Credit Rating
Q. Issuer Rating
R. Through the cycle rating
S. External Rating System Limitation

List II: (Focus Area)

1. Backward looking nature depending on past data
2. Focuses mainly on the permanent component of default risk
3. Issuer specific assessment of credit risk
4. Assessment of an entity's ability to pay its financial obligations

(A) P-4, Q-3, R-2, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-2, Q-1, R-4, S-3
(D) P-1, Q-2, R-3, S-4

Oct/Nov 2019

63. Basel II guidelines permit banks to use ratings provided by external agencies for risk weighting purposes. However, what is the most appropriate reason why banks are advised against exclusive dependence on external rating for taking credit decisions?

(A) Because external ratings are not approved by SEBI.
(B) Because external ratings are forward-looking and therefore too speculative for banking decisions.
(C) To avoid pricing errors by maintaining independent risk cross-checks.
(D) Because external agencies do not rate bank loans under any circumstances.

May/June 2017

64. The following question consists of two statements — Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.

Assertion (A): In a dynamic market framework, the backward-looking nature of credit ratings can have serious consequences, including accentuating a systemic crisis.

Reason (R): Credit ratings depend heavily on past data, and agencies often face limitations regarding the availability of granular forward-looking information on the financials of a company.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2020

65. Consider the following statements regarding the process followed by most credit rating agencies:

I The rating agreement has important clauses like confidentiality and the issuer's agreement to share information.
II During the management meeting, discussions cover strategy, financial policy, and near- and long-term business outlook.
III After discussion with the issuer's management, the rating decided by the rating committee is kept permanently secret from the requesting company.

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2016

66. Match the terms in List I with their corresponding summary definitions in List II:

List I: (Term)

P. External Rating
Q. Issue Rating
R. Point in time rating
S. Solicited Rating

List II: (Definition)

1. Tries to evaluate the current situation of a customer by taking into account both cyclical and permanent effects
2. Assessment and provision of an opinion on specific corporate and public-sector debt issues
3. Ratings conducted after being formally engaged by the issuer
4. Opinion on the creditworthiness or relative degree of risk of timely payment on a debt

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for category 3
(B) Daily for category 5 and weekly for category 3
(C) Half-yearly for category 5 and quarterly for category 3
(D) Annually for both category 5 and category 3

Oct/Nov 2022

29. Which of the following is an incorrect statement regarding the classification of risk parameters in a credit rating exercise?
(A) Current ratio and Quick ratio are sub-components of Liquidity Ratio.
(B) Interest Coverage ratio and DSCR are sub-components of Solvency Ratio.
(C) Return on assets and Operating Profitability are sub-components of Leverage Ratio.
(D) Management structure and Experience in similar industry are sub-components of Management Capability.

May/June 2006

30. Match the features of the internal credit rating system in List I with their corresponding descriptions in List II:
List I: (Feature)
P. Rating Standards
Q. MIS requirements
R. Grading system
S. Integration with risk management
List II: (Description)
1. Should form the foundation for credit risk assessment, measurement, monitoring, and reporting
2. Includes frequency distribution of assets across risk-rating scale and extent of migration
3. Adopts an alphabetic, numeric, or alpha-numeric scale
4. Utilizes benchmarks consisting of financial ratios and credit-migration statistics
(A) P-2, Q-4, R-1, S-3
(B) P-3, Q-1, R-4, S-2
(C) P-1, Q-3, R-2, S-4
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2006

31. Which of the following was set up in 1987, promoted by premier financial institutions like ICICI, HDFC, UTI, SBI, LIC, and Asian Development Bank, and is currently an S&P company with a majority shareholding?
(A) ICRA
(B) CARE
(C) CRISIL
(D) Acuité

May/June 2011

32. A private sector insurance company approaches a rating agency to enhance its market credibility. To determine the rating, what specific parameter will the rating agency evaluate to classify its capacity as high, adequate, moderate, or weak?
(A) Repayment of medium-term public deposits
(B) Claim paying ability
(C) Development of residential complexes
(D) Extent of deficit financing

Oct/Nov 2017

33. Consider the following statements regarding what an external credit rating implies:
I It measures other factors such as yield offered, liquidity risk, and pre-payment risk.
II It is not an indication of compliance or otherwise with legal or statutory requirements.
III Even the highest-rated instrument faces some risk of default.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2015

34. Which statement correctly differentiates between the Point In Time (PIT) and Through The Cycle (TTC) rating methodologies?
(A) TTC incorporates cyclical changes immediately, while PIT focuses on the permanent component of default risk.
(B) TTC methodology assigns more relative weight to the temporary component of credit quality than PIT.
(C) PIT is exclusively used for horizons longer than ten years, while TTC is strictly for a one-year horizon.
(D) PIT tracks credit changes as fortunes shift,

NODIA

May/June 2024

48. A retail investor purchases debentures of a corporation solely because they carry the highest credit rating, assuming this rating implies the shares are a recommended buy and guarantees zero risk of secondary market loss. Based on the limits of credit ratings, why is the investor's assumption flawed?
(A) Because rating agencies only audit statutory requirements, not market prices.
(B) A rating is no recommendation and excludes liquidity or market loss risks.
(C) Because the rating is only an opinion on the promoters of the rated entity.
(D) Because rating agencies in India are not approved by SEBI for debentures.

Oct/Nov 2018

49. A corporate issuer seeks an initial rating for a private debt instrument but is dissatisfied with the rating assigned by the committee. The issuer appeals for a fresh look, submitting new information. The committee discusses this but decides not to modify the rating. What is the issuer's remaining prerogative according to best global practices?
(A) The issuer can decline the rating to prevent its publication.
(B) The issuer must publish the rating immediately regardless of their disagreement.
(C) The issuer is mandated by SEBI to accept the unchanged rating for private debt.
(D) The issuer must legally convert the private debt into an IPO.

May/June 2010

50. In the external rating process, what is the conceptual difference between the role of the analytical team and the rating committee?
(A) The analytical team signs the agreement, while the rating committee gathers operational data.
(B) The analytical team is the final authority for assigning ratings, while the rating committee only meets the officials.
(C) The team analyzes risks, while the committee assigns the final rating.
(D) The analytical team publishes the rating to the press, while the rating committee appeals for a fresh look.

Oct/Nov 2005

51. The analytical framework used by credit rating agencies includes several specific types of analysis. Which of the following is NOT one of the main factors explicitly listed in the framework?
(A) Regulatory and Competitive Environment
(B) Fundamental Analysis
(C) Management Evaluation
(D) Derivative Options Pricing Analysis

May/June 2021

52. How is Issuer Rating (CIR) formally defined in the context of credit assessment?
(A) It is the provision of an opinion on specific corporate debt issues.
(B) It is an assessment that takes into account the probability of recovery of a specific rated debt.
(C) It is an assessment evaluating the current situation of a customer by taking into account both cyclical and permanent effects.
(D) It is issuer specific assessment of credit risk.

Oct/Nov 2015

53. Rating is applied to various related products and activities. For which of the following instruments is credit rating explicitly mentioned as optional since 2014 by SEBI?
(A) Commercial Papers (CPs)
(B) Bonds and debentures
(C) Equity share IPOs
(D) Fixed deposits

May/June 2008

54. The analytical framework used by Credit Rating Agencies (CRAs) analyzes several factors in detail. Which of the following is explicitly listed as a main factor analyzed by the credit rating agencies?
(A) Stock Market Volatility Analysis
(B) Intraday Trading Analysis
(C) Geographical Analysis
(D) Underwriting Commission Analysis

Oct/Nov 2009

55. The following question consists of two statements — Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): If an issuer disagrees with an

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regardless of the time horizon.

May/June 2020

42. The following question consists of two statements — Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): A credit rating is not a guarantee against default of the rated instrument.
Reason (R): Even the highest-rated instrument faces some risk of default, although the risks associated with this are lower than lower-rated instruments.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2014

43. A local chit fund operator collects monthly contributions and wishes to obtain a credit rating to attract more savers. On what specific basis will the external rating agency rate this chit fund?
(A) Its capacity to pay dividends on initial public offerings
(B) Its ability to pay prize money to subscribers on time
(C) Its claim paying ability for life insurance policies
(D) Its rate of agricultural and industrial production

May/June 2007

44. Match the rating entity or product in List I with its specific assessment basis or characteristic in List II:
List I: (Entity/Product)
P. Insurance companies
Q. Countries
R. Chit funds
S. Real estate developers
List II: (Assessment Basis)
1. Timely payment of prize money
2. Proper development of a colony or building flats
3. Claim paying ability
4. Industrial/agricultural production and rate of inflation
(A) P-4, Q-3, R-2, S-1
(B) P-1, Q-2, R-3, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-3, Q-4, R-1, S-2

Oct/Nov 2023

45. Which of the following is an incorrect statement regarding the Through the Cycle (TTC) rating methodology?
(A) It has a focus on the permanent component of default risk.
(B) It filters out the temporary component of default risk.
(C) It incorporates temporary fluctuations in default risk heavily.
(D) Only substantial changes in the permanent component of default risk lead to rating migrations under this method.

May/June 2019

46. A credit rating by External Rating Agencies does NOT signify several things. Which of the following is an exception (i.e., something it DOES signify or provide)?
(A) A recommendation to buy, hold, or sell any specific shares or bonds
(B) Opinion on the relative risk of timely payment of principal and interest
(C) An audit of the rated entity (statutory or non-statutory)
(D) A guarantee against default of the rated instrument

Oct/Nov 2011

47. How is "Solicited Rating" formally defined in the context of credit ratings?
(A) Ratings that credit rating agencies conduct entirely on their own initiative without issuer interaction.
(B) Ratings that credit rating agencies conduct after being formally engaged by the issuer to do so.
(C) Ratings that rely exclusively on past market cap data of the entity.
(D) Ratings mandated by the regulator regardless of the issuer's consent.

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Vested with External Credit Assessment Institutions
(D) Relationship management - Vested exclusively with the board of directors

Oct/Nov 2019

21. A bank determines the weighted credit score for a borrower based on the following weights: Business risk (30%), Financial risk (40%), Borrower risk (15%), and Conduct of account (15%). If the final calculated weighted percentage score obtained by the borrower is 72%, which risk rating will be assigned?
(A) ABC BNK 1
(B) ABC BNK 2
(C) ABC BNK 3
(D) ABC BNK 4

May/June 2017

22. A well-managed credit risk rating system aids banks in taking informed decisions on credit. Which of the following is NOT an enumerated use of the rating system for banks?
(A) Tracking risk migration patterns
(B) Audit of the rated entity
(C) Measuring incremental risk
(D) Determining pricing terms

Oct/Nov 2020

23. A corporate borrower's credit exposure is currently facing rapid and steady erosion in its financials, placing it on a downhill transition path on the bank's risk-rating scale. To manage this impending risk, what action should the bank's management proactively take?
(A) Provide a new low-risk high-return exposure
(B) Remove the exposure from the bank's internal MIS reports
(C) Shift the exposure directly to an External Credit Assessment Institution
(D) Execute anticipatory provisioning based on risk-rating calibrations

May/June 2016

24. Identify the incorrect pair regarding the principal risk components and their sub-parameters:
(A) Conduct of Account - Repayment History and Compliance of covenants
(B) Management Capability - Experience and Collateral Positional
(C) Industry Risk - Industry specific and Industry drivers
(D) Financial Risk - Business cycle and Economic conditions

Oct/Nov 2012

25. In a conventional bank, an executive working in the front-office relationship team evaluates a new loan proposal. According to the ideal features of an internal credit rating system, what is the appropriate limit of this executive's authority regarding the risk rating?
(A) The executive can assign the risk-rating, approve it, and monitor it independently.
(B) The executive assigns risk ratings, while separate staff handle approval and monitoring.
(C) The executive can approve the risk-rating but cannot assign the initial grade.
(D) The executive must transfer all rating tasks to an external credit rating agency.

May/June 2025

26. Which of the following statements is correct regarding the ability to pay financial obligations?
(A) It is referred to as credit exposure.
(B) It is referred to as credit migration.
(C) It is referred to as operational leverage.
(D) It is referred to as credit worthiness.

Oct/Nov 2008

27. A credit analyst is computing the financial risk score for a borrower. In the credit rating system, if the borrower's Current Ratio is calculated as 1.29, what score is obtained for this parameter based on the scoring scale?
(A) 5
(B) 3
(C) 1
(D) 0

May/June 2009

28. A bank decides to structure its credit administration and post-disbursement surveillance based on the assigned internal risk categories. The bank places a borrower in category 5 and another in category 3. Based on the credit administration practices, what should be the most appropriate frequency of surveillance for these categories?
(A) Quarterly for category 5 and half-yearly

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initial rating, they can choose not to accept the rating, which then does not get published (except for public issues of debt in India).
Reason (R): The best global practice is to allow the issuer to decide whether to accept the rating, as obtaining an initial rating is at the issuer's discretion.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2013

56. Consider the following statements distinguishing issuer rating and issue rating:
I To assess the creditworthiness of an issuer, Credit Rating Agencies (CRAs) evaluate the issuer's ability and willingness to repay its obligations in accordance with the terms of those obligations.
II In rating an individual debt issue, CRAs ignore the creditworthiness of the issuer and only evaluate the specific bond's collateral.
Which of the above statement(s) is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2025

57. Which of the following correctly highlights a serious limitation of the external rating system?
(A) Dependence on past data can worsen systemic crises during a downturn.
(B) They are overly reliant on real-time continuous market valuations.
(C) They capture tail risks too aggressively, causing market panic unnecessarily.
(D) They provide absolute certainty regarding the future probability of default.

May/June 2005

58. Which of the following statements correctly describes the impact of Basel II guidelines on unrated bank loans?
(A) A bank choosing to keep loans unrated receives a risk weight of 0 per cent.
(B) A bank choosing to keep loans unrated must provide a risk weight of 50 per cent.
(C) Unrated loans may require risk weights of 100 per cent or higher.
(D) Unrated bank loans are strictly prohibited under Basel II instructions.

Oct/Nov 2010

59. Which methodology focuses mainly on the permanent component of default risk and is nearly independent from cyclical changes in the creditworthiness of a customer?
(A) Point in time (PIT) rating
(B) Unsolicited Issue rating
(C) Through the cycle (TTC) rating
(D) Tail risk rating

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May/June 2022

60. Arrange the initial steps of the multi-layered decision-making process for external credit rating in the correct chronological order:
I Appointment of analytical team
II Agreement
III Meeting the officials
IV Obtaining information
(A) (II), (I), (IV), (III)
(B) (I), (II), (III), (IV)
(C) (II), (IV), (I), (III)
(D) (I), (IV), (II), (III)

Oct/Nov 2016

61. Consider the following macroeconomic and governance factors utilized while rating a country:
I Industrial and agricultural production
II Gross domestic product
III Government policies
IV Rate of inflation
V Extent of deficit financing
Which of the above statement(s) is/are correct?
(A) (I), (II), (IV), and (V) only
(B) (II), (III), (IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

ANSWERS

1. (D) Identify the provisioning required for expected losses.
When credit exposures migrate to unacceptable risk categories, internal guidelines mandate quantifying potential losses. This process involves calculating the specific provisioning required to cover expected credit losses. Such proactive identification ensures the bank maintains adequate capital buffers against deteriorating assets, facilitating better risk management and regulatory compliance within the financial institution's credit framework.

2. (B) (III), (I), (II), (IV)
The process of assigning a risk rating begins with identifying principal business and financial risk elements. Once identified, weights are allocated to these main risk components. Subsequently, key parameters or sub-components are established for detailed evaluation. Finally, specific weights are assigned to each key parameter to arrive at a comprehensive and quantified risk score.

3. (C) It provides a forward-looking assessment of relative creditworthiness.
A credit rating serves as a forward-looking assessment of an entity's relative creditworthiness. It evaluates the probability of timely repayment of financial obligations based on current and projected data. Unlike historical audits, ratings focus on future debt-serving capacity, providing investors and lenders with a standardized measure of the risk associated with a particular borrower.

4. (C) (I), (II), (III), and (IV)
Parameters categorized under "Conduct of Account" specifically monitor how a borrower manages their credit facility. Key indicators include timely payments, adherence to sanction terms, and the absence of fund diversification or devolvement of bank guarantees and letters of credit. These factors reflect the borrower's operational discipline and financial reliability in managing their existing debt obligations.

5. (B) The Credit Risk Rating (CRR) system
The Credit Risk Rating system is the primary tool used by banks to evaluate changes in overall and incremental risk when adding new clients or facilities. It provides a structured framework to quantify the impact of new exposures on the existing portfolio. By assigning ratings at entry, banks can systematically track and manage portfolio risk levels.

6. (A) 5
In standard financial scoring models for credit risk, a Debt Service Coverage Ratio (DSCR) exceeding 2.0 typically indicates superior debt-servicing capacity. Consequently, this performance level is awarded the maximum possible score, which is often 5 marks. Such scoring mechanisms help quantify financial risk parameters consistently across different borrowers, enabling objective comparison of their financial health and repayment ability.

7. (B) Credit rating
A credit rating represents a formalized assessment of an entity's ability to honor its financial obligations. It provides a symbolic indicator of creditworthiness, reflecting the likelihood of timely principal and interest payments. This evaluation considers various financial and non-financial factors, helping lenders and investors gauge the relative risk associated with providing credit to a specific borrower.

8. (A) (I), (II), and (III) only
Effective internal credit rating frameworks require that all exposures be rated using unambiguous grades that clearly represent default risks. Since no single system fits every institution, customization is essential to suit specific operational needs. Crucially, the responsibilities for final approval and monitoring must remain independent from relationship management to prevent conflicts of interest and maintain objectivity.

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instrument
(A) P-1, Q-2, R-3, S-4
(B) P-2, Q-4, R-3, S-1
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-1, S-3

Oct/Nov 2012

67. Consider the following characteristics regarding the limits and functions of rating agencies:
I They can suffer from failure and unwillingness to capture/cover market risks.
II Their ability to read risk improves with more granular information on the financials of the company.
III A truly forward-looking rating could potentially capture tail risks.
IV No product can be usefully rated in a vacuum, isolated from the market's caprices.
V Ratings rely heavily on anticipating panic and knee-jerk reactions to trigger immediate unresearched downgrades.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (V) only
(B) (I), (II), (III), and (IV) only
(C) (II), (III), (IV), and (V) only
(D) (I), (III), (IV), and (V) only

May/June 2025

68. Consider the following elements of information obtained by the analytical team in a rating agency:
I Financial position and cash flows
II Nature and basis of competition and market share
III Operating efficiency arrangements and management's track cost structure
IV Selling and distribution record, power, and labour situation
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2008

69. Consider the following statements regarding bank loans and risk weights:
I By getting loans rated, a bank can save capital on loans in the better rated categories.
II Certain kinds of loans carry variable risk weights depending upon their perceived risks, which are worked out to assess the capital to be maintained.
Which of the above statement(s) is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) is correct
(D) Neither (I) nor (II) is correct

May/June 2009

70. When utilizing the Point In Time (PIT) methodology, a credit rating agency is assigning weights to the temporary and permanent components of credit quality. The assigned rating is valid for a one-year horizon. What logical conclusion follows regarding the relative weight applied in this scenario?
(A) The temporary component will be entirely excluded to prevent cyclical volatility.
(B) Shorter horizons may result in higher weights for the temporary component.
(C) The permanent component will be the sole driver of the rating decision.
(D) Relative weights are kept uniform regardless of the specific rating time horizon.

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while TTC ignores short-term cycles.

Oct/Nov 2013

35. Consider the following rating-related products and their characteristics:

I Credit rating for short-term instruments like Commercial Papers (CPs) is mandatory.

II Chit funds are rated on the basis of their ability to make timely payment of prize money to subscribers.

III Rating of preference shares is widely performed by all Indian rating agencies on a mandatory basis.

IV Insurance companies are rated on the basis of their claim paying ability.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (II), and (IV) only
(D) (I), (III), and (IV) only

May/June 2023

36. Which of the following is an incorrect statement concerning the limitations of external credit rating systems?

(A) They are known for their strong willingness and success in capturing and covering market risks perfectly.
(B) They depend heavily on the availability of information on the financials of the company.
(C) A really informed forward-looking rating could potentially capture tail risks and forewarn the system.
(D) No product can be usefully rated in a vacuum, isolated from the caprices of the market.

Oct/Nov 2021

37. The history of systematic credit rating is a century old. Who began this practice by rating US railroad bonds, and in which year?

(A) John Moody in 1909
(B) Standard and Poor's in 1923
(C) Fitch in 1913
(D) John Moody in 1887

May/June 2018

38. Identify the incorrect pair regarding the steps in the credit rating process and their description:

(A) Agreement - Covers details about terms and conditions and confidentiality clauses.
(B) Meeting the officials - The analytical team interacts with the client's executives to obtain clarifications.
(C) Revision of the rating - The rating agency monitors all ratings during the life of the instrument.
(D) The agency publishes ratings exclusively in private prospectuses.

Oct/Nov 2007

39. Which rating approach tries to evaluate the current situation of a customer by taking into account both cyclical and permanent effects?

(A) Through the cycle (TTC) rating
(B) Forward looking baseline rating
(C) Segmented portfolio rating
(D) Point in time (PIT) rating

May/June 2012

40. An external credit rating agency is tasked with rating a sovereign national government. Which attributes will the analysis primarily concentrate on?

(A) Individual borrower repayment history and collateral position.
(B) Only the anticipated ups and downs of the specific industry cycle.
(C) The probability of recovery associated with a specific municipal bond.
(D) Fiscal performance, monetary stability, and institutional effectiveness.

Oct/Nov 2024

41. When dealing with time horizons for which a rating is valid, how does the Point In Time (PIT) approach generally handle the weighting of risk components compared to a longer time horizon?

(A) For a one-year horizon, the permanent component is the only factor considered.
(B) The temporary component may receive more weight for shorter time horizons.
(C) For a longer time horizon, the temporary component receives 100% weightage.
(D) The weighting between temporary and permanent components remains static

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9. (B) Interest Coverage Ratio - Solvency Ratio
Financial risk analysis involves categorizing specific ratios under broader parameters. The Interest Coverage Ratio is a fundamental sub-component of Solvency Ratios, as it measures an entity's ability to meet its interest payments. Other classifications like Current Ratio fall under Liquidity, while Return on Assets belongs to Profitability, ensuring a comprehensive evaluation of the borrower's financial stability.

10. (A) (I) and (II) only
Well-designed credit scoring systems enable consistent, impartial, and rapid evaluation of numerous applications. Accurate rating scales help prevent pricing errors that lead to risk/return imbalances or adverse selection. Furthermore, these scales are vital for determining the necessary frequency and intensity of monitoring, ensuring that higher-risk exposures receive more frequent surveillance and closer management attention throughout their tenure.

11. (C) Risk requires attention
Credit rating assignment scales map weighted percentage scores to specific risk descriptions. A score of 55% typically falls into a category indicating that the risk requires attention. This classification serves as an early warning for bank management, signaling that while the exposure is not yet unacceptable, it necessitates closer monitoring or corrective measures to prevent further deterioration.

12. (C) By prescribing a maximum threshold rating grade, a bank ensures all high-risk exposures are automatically approved.
Banks utilize rating scales to define acceptable and unacceptable risk categories, setting minimum entry-point ratings to screen proposals. However, prescribing a maximum threshold does not ensure automatic approval of high-risk exposures; rather, it identifies the boundary beyond which risks are considered unacceptable. The system is designed to filter out excessive risk, not to bypass rigorous credit standards.

13. (A) The internal MIS requirements linked to the Credit Risk Framework
Internal Management Information System (MIS) requirements linked to the credit risk framework are essential for reviewing the frequency distribution of assets. These reports allow senior management to track the movement of exposures across the risk-rating scale and anticipate portfolio developments. This data-driven approach supports strategic decisions when shifting the bank's risk appetite from low-return to high-return exposures.

14. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
The board of directors is responsible for approving the credit risk rating system and ensuring clear accountability within the process. Simultaneously, the board requires sufficient information to oversee management's implementation of these systems. While both statements are factually correct, the need for information describes the oversight mechanism rather than providing the fundamental reason for the board's approval authority.

15. (C) 3
Financial risk scoring models utilize specific ranges to assign marks to leverage ratios. For the Total Outside Liabilities to Tangible Net Worth (TOL/TNW) parameter, a ratio of 3.50 falls within the bracket of 3.0 to 4.0. According to the established scoring scale, this performance level earns 3 marks, contributing to the borrower's total financial risk score.

16. (A) Because a major part of the assets in a bank's balance sheet are loan assets
Credit risk is considered the most significant risk for banks because loan assets constitute the largest portion of their balance sheet. Since interest from loans is a primary income source, any failure by borrowers to meet repayment obligations directly impacts the bank's profitability and capital. Consequently, managing credit risk is central to maintaining the institution's financial stability.

17. (A) P-3, Q-2, R-4, S-1
Financial analysis utilizes specific ratios categorized by their function. The Quick Ratio

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issuer's ability and willingness to honor all its financial obligations. Unlike an issue rating, which pertains to a specific debt instrument, the issuer rating provides a general opinion on the entity's financial strength.

53. (C) Equity share IPOs
Since 2014, SEBI has made credit rating optional for equity share Initial Public Offerings (IPOs) in India. Previously, IPO grading was mandatory to provide investors with an independent assessment of the issue's fundamentals. While still available as a voluntary service, issuers are no longer legally required to obtain a grade from a rating agency before launching an equity IPO.

54. (C) Geographical Analysis
Credit rating agencies utilize a comprehensive framework that includes geographical analysis to assess how an entity's location and regional economic conditions impact its creditworthiness. Other core factors include management evaluation, industry analysis, and fundamental financial assessment. This broad approach ensures that the rating reflects all significant risks, including those arising from the specific regions where the issuer operates.

55. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Global best practices allow issuers to decide whether to accept and publish an initial rating because the decision to seek a rating is voluntary. If an issuer disagrees with the assigned grade, they can choose not to accept it, thereby preventing its public dissemination. This principle respects the issuer's discretion, although regulatory requirements in specific markets may mandate publication for public debt.

56. (A) Only (I) is correct
To assess an issuer's creditworthiness, agencies evaluate their overall ability and willingness to repay obligations. However, when rating an individual debt issue, agencies do not ignore the issuer's creditworthiness. Instead, they start with the issuer's general capacity and then adjust for specific features of the bond, such as collateral, seniority, or other credit enhancements that affect recovery.

57. (A) Dependence on past data can worsen systemic crises during a downturn.
A significant limitation of external rating systems is their heavy reliance on historical financial data. This backward-looking nature can be problematic during rapid economic downturns, as ratings may fail to reflect current risks timely. Such delays in downgrading can lead to sudden, sharp adjustments that exacerbate market volatility and potentially accentuate systemic financial crises.

58. (C) Unrated loans may require risk weights of 100 per cent or higher.
Under Basel II guidelines, banks using external ratings for risk weighting must apply higher capital charges to unrated exposures. Typically, unrated corporate loans are assigned a risk weight of 100 per cent, which may be even higher depending on the regulator's assessment. Getting loans rated can therefore help a bank reduce its capital requirements if the borrowers receive favorable credit ratings.

59. (C) Through the cycle (TTC) rating
The Through The Cycle (TTC) rating methodology prioritizes the permanent component of an entity's default risk and is designed to be largely independent of cyclical fluctuations. By ignoring short-term economic changes, TTC ratings provide a stable measure of long-term creditworthiness. This approach is useful for investors and lenders who require a consistent risk assessment across different economic environments.

60. (A) (II), (I), (IV), (III)
The external credit rating process begins with a formal agreement between the agency and the issuer. Following this, an analytical team is appointed to handle the assignment. The team then obtains necessary financial and operational information from the issuer. Finally, they meet with the issuer's officials to discuss strategy and clarify details before the rating is finalized.

NODIA

61. (D) (I), (II), (III), (IV), and (V)
Rating a country involves a comprehensive evaluation of its macroeconomic and governance

their financial obligations in a timely manner. It is the fundamental quality evaluated during the credit rating process. Higher creditworthiness indicates a lower probability of default, whereas lower creditworthiness suggests a higher risk that the borrower may fail to honor their debt commitments.

27. (B) 3
Credit scoring scales assign specific marks to liquidity ratios based on defined ranges. For a Current Ratio of 1.29, the borrower typically earns 3 marks under standard financial risk assessment criteria. This score reflects a moderate level of liquidity, indicating that the entity has sufficient current assets to cover its short-term liabilities, albeit with a limited safety margin.

28. (A) Quarterly for category 5 and half-yearly for category 3
The frequency of post-disbursement surveillance is determined by the internal risk category assigned to a borrower. Higher-risk categories, such as category 5, require more frequent monitoring, typically on a quarterly basis. Conversely, lower-risk categories like category 3 necessitate less intensive oversight, often conducted half-yearly. This tiered approach ensures that resources are focused on higher-risk exposures.

29. (C) Return on assets and Operating Profitability are sub-components of Leverage Ratio.
Return on assets and operating profitability are sub-components of profitability ratios, not leverage ratios. Leverage ratios typically include measures like the Debt Equity Ratio and Total Outside Liabilities to Tangible Net Worth. Correct classifications involve grouping liquidity ratios like Current and Quick ratios together, and solvency ratios like DSCR and Interest Coverage under their respective broader categories.

30. (D) P-4, Q-2, R-3, S-1
Internal credit rating systems utilize rating standards consisting of financial benchmarks and migration statistics. MIS requirements track the frequency distribution of assets and migration patterns. The grading system typically employs alphanumeric scales to represent risk levels. Integration with risk management ensures these ratings form the foundation for assessing, measuring, monitoring, and reporting credit risk across the bank.

31. (C) CRISIL
CRISIL was established in 1987 as India's first credit rating agency, promoted by leading financial institutions including ICICI, SBI, and HDFC. It is currently a subsidiary of S&P Global, which holds a majority stake. CRISIL provides a wide range of ratings, research, and advisory services, playing a pivotal role in the development of India's debt market.

32. (B) Claim paying ability
When rating an insurance company, agencies specifically evaluate its claim-paying ability. This parameter assesses the insurer's financial strength and capacity to honor obligations to policyholders. Ratings classify this ability into categories ranging from high to weak, providing a benchmark for policyholders and investors to judge the company's reliability in fulfilling its core business promise of indemnification.

33. (B) (II) and (III) only
An external credit rating is an opinion on credit risk and does not signify compliance with legal or statutory requirements. It is important to note that even the highest-rated instruments carry some risk of default, however minimal. Ratings primarily measure the relative probability of timely repayment and do not assess other factors such as yield or liquidity risk.

34. (D) PIT tracks credit changes as fortunes shift, while TTC ignores short-term cycles.
The Point In Time (PIT) methodology evaluates a borrower's current situation by considering both cyclical and permanent effects, causing ratings to shift as economic conditions change. In contrast, the Through The Cycle (TTC) approach focuses on the permanent component of default risk, filtering out temporary fluctuations. This results in more stable ratings that only change with fundamental shifts in creditworthiness.

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May/June 2008

6. Read the following scenario and answer the question that follows:

Company Alpha supplies a unique intermediate component to Company Beta. Company Beta processes this component and sells the finished product in the market. Company Alpha derives 55% of its annual gross receipts directly from its transactions with Company Beta. Furthermore, Company Alpha has fully guaranteed a substantial bank loan undertaken by Company Beta.

Under which primary criterion are Company Alpha and Company Beta considered connected counterparties by the lending bank?

(A) Control relationship established through shared voting agreements.
(B) Economic interdependence via gross receipts and loan guarantees.
(C) Significant influence on the decision-making of senior management.
(D) Exempted sovereign dependency as defined by the central regulator.

Oct/Nov 2017

7. According to the evolving perspective on credit risk management, which of the following is an underlying recognition for measuring risk at the portfolio level?

(A) Traditional binary classification of credits into good and bad is fully sufficient for modern risk measurement.
(B) All credits can potentially become bad over time given a particular economic scenario.
(C) Only good credits have the inherent potential to remain good over time despite economic shifts.
(D) Secondary loan markets have no significant impact on the proactive management of credit exposures.

May/June 2006

8. Read the following scenario and answer the question that follows:

LMN Bank has a credit portfolio of ₹1 billion. The infrastructure sector accounts for 25% of the credit portfolio. The two largest customers, belonging to the infrastructure construction company, account for 30% of the portfolio. Long-term credit assets exceeding one year account for 60% of the portfolio, while 75% of the total funding requirements come from short-term institutional deposits and inter-bank borrowings.

Based on typical prudent bank policy, to what level should the infrastructure sector concentration ideally be reduced to mitigate sectoral downturn vulnerability?

(A) 10% to 15%
(B) 3% to 5%
(C) 1% to 2%
(D) 20% to 25%

Oct/Nov 2008

9. How is a bank's exposure to an exempted entity treated if it is hedged by a credit derivative?

(A) It remains completely exempted from all Large Exposure Framework limits and reporting.
(B) It is treated as an exposure to the counterparty providing the credit protection.
(C) It is deducted immediately from the bank's Tier 1 capital as a capital charge.
(D) It is treated as an intra-day interbank exposure with a zero risk-weighting.

May/June 2024

10. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option.

Assertion (A): Any build-up of excessive exposure to the construction sector during a boom time can spell trouble when a downturn arrives.

Reason (R): Sensitivity to business cycles is uniform across all sectors, making the construction industry equally vulnerable as any other sector.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2021

11. Why would a reduction in orders from a dominant buyer (Company Beta) cause

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help potential savers evaluate the operational reliability and financial safety of participating in a particular chit fund scheme.

44. (D) P-3, Q-4, R-1, S-2
Different entities are assessed on specialized criteria. Insurance companies are rated on their claim-paying ability, while countries are evaluated based on macroeconomic factors like industrial production and inflation. Chit funds are rated on the timely payment of prize money, and real estate developers are assessed on their ability to properly develop and complete building projects or colonies.

45. (C) It incorporates temporary fluctuations in default risk heavily.
The Through The Cycle (TTC) rating methodology is designed to filter out temporary fluctuations in default risk, rather than incorporating them heavily. It focuses on the permanent component of a borrower's credit quality, resulting in ratings that remain stable across different stages of the economic cycle. Only significant changes in the underlying permanent factors will lead to a rating migration.

46. (B) Opinion on the relative risk of timely payment of principal and interest
A credit rating signifies an agency's opinion on the relative risk regarding the timely payment of principal and interest on a debt instrument. It does not provide a recommendation to buy or sell securities, nor does it constitute a guarantee against default or a statutory audit. Its primary purpose is to offer a standardized measure of creditworthiness for market participants.

47. (B) Ratings that credit rating agencies conduct after being formally engaged by the issuer to do so.
A solicited rating is formally defined as a credit assessment conducted by a rating agency after being officially engaged and paid by the issuer. In this arrangement, the issuer actively participates in the process by providing detailed internal information and facilitating management meetings. This collaboration allows for a more comprehensive and in-depth analysis compared to unsolicited ratings.

48. (B) A rating is no recommendation and excludes liquidity or market loss risks.
An investor's assumption that a high credit rating guarantees no secondary market loss is flawed because ratings only assess credit risk—the ability to repay debt. They are not recommendations to buy and do not cover liquidity risk or the risk of price fluctuations in the secondary market. Ratings focus exclusively on the probability of timely principal and interest payments.

49. (A) The issuer can decline the rating to prevent its publication.
According to best global practices, if an issuer is dissatisfied with a rating even after an appeal, they generally have the prerogative to decline the rating. By doing so, the issuer can prevent the rating from being published. However, this right may be restricted in certain jurisdictions or for specific types of public debt issues where publication is mandatory.

50. (C) The team analyzes risks, while the committee assigns the final rating.
In the external rating process, a clear distinction exists between the roles of the analytical team and the rating committee. The analytical team is responsible for gathering data, meeting with management, and performing the detailed risk analysis. Their findings are then presented to the rating committee, which acts as the final authority to deliberate and assign the official rating.

51. (D) Derivative Options Pricing Analysis
The standard analytical framework for credit ratings includes fundamental analysis, management evaluation, and an assessment of the regulatory and competitive environment. It focuses on factors that directly impact an entity's ability to service its debt. Derivative options pricing analysis is a specialized financial modeling technique used for trading and valuation, rather than a core component of credit risk assessment.

52. (D) It is issuer specific assessment of credit risk.
An Issuer Rating, often referred to as a Corporate Indicator Rating (CIR), is an assessment specifically focused on the overall creditworthiness of an entity. It evaluates the

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35. (C) (I), (II), and (IV) only
Credit ratings are mandatory for short-term instruments like Commercial Papers and for certain public debt issues. Chit funds are rated based on their ability to pay prize money to subscribers on time. Similarly, insurance companies receive ratings reflecting their claim-paying ability. However, the rating of preference shares is not universally mandatory for all Indian rating agencies.

36. (A) They are known for their strong willingness and success in capturing and covering market risks perfectly.
External credit ratings have inherent limitations and are not designed to capture or cover market risks perfectly. They depend heavily on the availability of historical financial information and may fail to anticipate sudden market shifts. While forward-looking ratings aim to capture tail risks, they are not a substitute for market analysis and cannot operate in isolation from economic volatility.

37. (A) John Moody in 1909
Systematic credit rating began in 1909 when John Moody started rating US railroad bonds. This pioneering effort introduced a standardized method for assessing the creditworthiness of debt instruments. Following this, other major agencies like Fitch and Standard & Poor's were established, leading to the global industry that provides essential risk assessment services for modern financial markets.

38. (D) The agency publishes ratings exclusively in private prospectuses.
Credit rating agencies do not publish ratings exclusively in private prospectuses. Once a rating is accepted by the issuer, it is typically disseminated to the public through press releases and the agency's website. This transparency is crucial for informing investors and market participants about the relative credit risk associated with the rated instrument or entity.

39. (D) Point in time (PIT) rating
The Point In Time (PIT) rating approach evaluates a customer's creditworthiness by accounting for both current cyclical economic conditions and permanent financial traits. This methodology provides a snapshot of the borrower's risk at a specific moment. Consequently, PIT ratings are more sensitive to short-term changes in the economic environment compared to more stable, long-term rating methodologies.

40. (D) Fiscal performance, monetary stability, and institutional effectiveness.
Rating agencies assessing a sovereign national government focus on macro-level indicators rather than individual collateral. Primary attributes include fiscal performance, monetary stability, and institutional effectiveness. These factors determine the nation's ability and willingness to service its debt. The analysis also considers economic growth, inflation rates, and the external balance of payments to arrive at a sovereign rating.

41. (B) The temporary component may receive more weight for shorter time horizons.
In the Point In Time (PIT) methodology, the relative weight assigned to temporary and permanent risk components varies based on the rating's time horizon. For shorter horizons, such as one year, the temporary component representing current cyclical conditions may receive more weight. This allows the rating to reflect immediate risks more accurately, whereas longer horizons would prioritize more stable, permanent factors.

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42. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
A credit rating is an opinion on relative risk and never serves as a guarantee against default. This is because even instruments with the highest possible ratings still face some residual risk of default, albeit significantly lower than those with poorer ratings. The rating simply indicates the relative likelihood of repayment based on available information at a given time.

43. (B) Its ability to pay prize money to subscribers on time
External rating agencies assess chit funds based on their ability to pay prize money to subscribers in a timely manner. This specific assessment focuses on the operator's liquidity management and the integrity of the fund's cash flows. By providing this rating, agencies

indicators. Agencies analyze industrial and agricultural production, Gross Domestic Product, and government policies. They also monitor the rate of inflation and the extent of deficit financing. Together, these factors provide a complete picture of the sovereign's economic health and its ability to service national debt obligations.

62. (A) P-4, Q-3, R-2, S-1
Credit rating is the general assessment of an entity's ability to pay obligations. Issuer rating provides a specific assessment of the entity's overall creditworthiness. Through the cycle rating focuses on the permanent component of default risk to ensure stability. A key limitation of external rating systems is their backward-looking nature, as they rely heavily on historical financial data.

63. (C) To avoid pricing errors by maintaining independent risk cross-checks.
While Basel II allows the use of external ratings, banks are advised to maintain independent internal risk assessments. Relying solely on external agencies can lead to pricing errors if the ratings are delayed or fail to capture bank-specific information. By performing cross-checks, banks ensure more accurate risk-based pricing and a more robust understanding of their credit exposures' true risk profile.

64. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The backward-looking nature of credit ratings can indeed accentuate systemic crises in dynamic markets. This occurs because agencies depend on past financial data and often lack access to real-time, granular forward-looking information. Consequently, rating changes may lag behind actual economic shifts, leading to abrupt market reactions when downgrades finally occur, which can destabilize the broader financial system.

65. (A) (I) and (II) only
The rating process involves a formal agreement with confidentiality clauses and requirements for information sharing. Management meetings are crucial for discussing the issuer's business outlook and financial policies. However, the resulting rating is not kept secret from the company; instead, it is communicated to the issuer for acceptance before any public dissemination or use in financial markets.

66. (D) P-4, Q-2, R-1, S-3
External rating is an opinion on the creditworthiness of a debt instrument. Issue rating is an assessment of specific corporate or public-sector debt issues. Point in time rating evaluates a customer's current situation by considering both cyclical and permanent effects. Solicited ratings are those conducted by agencies after being formally engaged and provided with information by the issuer.

67. (B) (I), (II), (III), and (IV) only
Rating agencies face limitations, including a potential failure to capture market risks and a heavy reliance on the quality of available financial information. While forward-looking ratings aim to identify tail risks, no rating can be entirely isolated from market caprices. Crucially, professional ratings are based on research rather than unresearched knee-jerk reactions or anticipating market panic to trigger downgrades.

68. (D) (I), (II), (III), and (IV)
To perform a thorough credit assessment, the analytical team gathers diverse information. This includes financial positions and cash flows, as well as the nature of competition and market share. They also examine operating efficiency, cost structures, and management's track record. Furthermore, factors like selling and distribution records, power supply, and labour situations are evaluated to understand the issuer's operational risks.

69. (C) Both (I) and (II) is correct
Banks can optimize their capital by having loans rated, as better-rated categories attract lower risk weights and thus require less capital. Regulatory frameworks assign variable risk weights based on perceived risks to determine the necessary capital buffers. By accurately assessing these risks through ratings, banks can more efficiently manage their balance sheets and maintain compliance with capital adequacy requirements.

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is a Liquidity Ratio measuring short-term debt-serving ability. The Debt Service Coverage Ratio (DSCR) is a Solvency Ratio assessing the capacity to cover debt obligations. Debt Equity Ratio represents a Leverage Ratio, while Return on Assets is a Profitability Ratio evaluating earnings relative to asset base.

18. (C) Both (I) and (II) are correct
The admission of new customers significantly influences a bank's credit risk profile based on their assigned entry-point ratings. Additionally, tracking risk migration is a critical practice for assessing portfolio quality over time. By monitoring how individual ratings move across the scale, banks can identify trends in credit deterioration or improvement, allowing for proactive risk management strategies.

19. (D) External Risk sub-components
In a comprehensive credit rating model, factors such as the business cycle and general economic conditions are categorized as external risk sub-components. These indicators represent macro-level influences that are outside the borrower's direct control but significantly impact their ability to generate revenue and repay debt. Evaluating these factors helps in understanding the broader environment affecting creditworthiness.

20. (A) Assigning the initial risk-ratings - Vested with conventional relationship staff
In conventional banking structures, the initial assignment of risk ratings is typically vested with relationship management staff who have direct interaction with the borrower. However, to ensure objectivity and avoid conflicts of interest, the final approval and subsequent monitoring of these ratings must be handled by a separate group of officials independent of the front-office team.

21. (B) ABC BNK 2
A weighted credit score of 72% corresponds to a specific grade on the bank's internal rating scale. According to standard alphanumeric scales where higher percentages reflect better credit quality, a score in this range typically aligns with the "ABC BNK 2" rating. This grade indicates a high level of creditworthiness with relatively low probability of default.

22. (B) Audit of the rated entity
While internal credit rating systems are vital for tracking risk migration, measuring incremental risk, and determining loan pricing, they are not intended for performing audits of the rated entity. Auditing is a separate professional function involving the verification of financial statements. Rating systems instead focus on assessing and quantifying credit risk to support informed lending decisions.

23. (D) Execute anticipatory provisioning based on risk-rating calibrations
When a borrower's financials erode rapidly, indicating a downward transition on the risk-rating scale, management must take proactive measures. Calibrating the rating system to trigger anticipatory provisioning allows the bank to set aside funds for expected losses before a formal default occurs. This forward-looking approach strengthens the bank's financial resilience against deteriorating asset quality within the portfolio.

24. (D) Financial Risk - Business cycle and Economic conditions
Business cycles and economic conditions are categorized as external risks rather than financial risks. Financial risk parameters typically involve internal ratios like liquidity, solvency, and profitability derived from the borrower's financial statements. Correct pairings include conduct of account with repayment history, management capability with experience, and industry risk with specific industry drivers and market dynamics.

25. (B) The executive assigns risk ratings, while separate staff handle approval and monitoring.
An ideal internal credit rating system necessitates the segregation of duties to ensure independence. While a front-office relationship executive may be responsible for the initial assignment of risk ratings based on their client knowledge, they should not have the authority to approve or monitor them. Separate staff must perform the approval and monitoring functions to maintain objectivity.

26. (D) It is referred to as credit worthiness.
Creditworthiness is defined as an assessment of a borrower's ability and willingness to meet

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CHAPTER 09
Portfolio Credit Risk

Oct/Nov 2023

1. Match the components of Diversifiable Risk in List I with their respective structural attributes in List II and select the correct option.
List I: (Diversifiable Risk Component)
P. Concentration risk
Q. Correlation risk
R. Portfolio funding risk
S. Diversifiable risk
List II: (Structural Attribute)
1. Contains sub-categories like Sector correlation and Default correlation
2. Contains sub-categories like Location/ region/country and Collateral risk
3. Forms the top-level classification encompassing all these risks
4. Distinct branch alongside Concentration and Correlation with no further sub-branches shown

(A) P-1, Q-2, R-4, S-3
(B) P-3, Q-4, R-1, S-2
(C) P-2, Q-4, R-3, S-1
(D) P-2, Q-1, R-4, S-3

May/June 2011

2. Under the Large Exposure Framework (LEF), what defines a "Large Exposure"?
(A) Total exposure of a bank to a counterparty equal to or above 15% of the Tier 2 capital.
(B) Any single exposure that exceeds 25% of the total risk-weighted assets of the entire bank.
(C) Total exposure to a counterparty equal to or above 10% of the Tier 1 capital base.
(D) Any individual exposure to a connected group that exceeds 5% of the bank's total net worth.

Oct/Nov 2012

3. Read the following scenario and answer the question that follows:
A bank maintains a portfolio of 500 credit customers enjoying working capital facilities, all rated as acceptable under the bank's credit policy. The bank is evaluating various distribution scenarios for this portfolio.
In which of the following scenarios would the portfolio credit risk be the highest?
(A) The portfolio is equally distributed between two different regions.
(B) The portfolio is equally distributed among ten different regions and ten unrelated industries.
(C) All 500 customers are concentrated in the same region or locality.
(D) The portfolio is equally distributed among three different, unrelated industry segments.

May/June 2015

4. For the purpose of the Large Exposure Framework limits, the eligible capital base is defined as the effective amount of which capital tier, as per the last audited balance sheet?
(A) Tier 1 and Tier 2 capital combined
(B) Tier 2 capital only
(C) Tier 1 capital only
(D) Common Equity Tier 1 (CET1) only

Oct/Nov 2013

Which of the following statements correctly describes the foreign currency concentration risk?
(A) Currency risk arises significantly when credit assets and related liabilities are both in local currency.
(B) Interest rate hikes by central banks shift forex flows, putting pressure on domestic currency values.
(C) Reliance on cheap foreign currency loans to finance local assets is ideal if the currencies are pegged.
(D) Sudden devaluation of local currencies eliminates the crises for businesses relying on foreign loans.

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70. (B) Shorter horizons may result in higher weights for the temporary component.

When using the Point In Time (PIT) methodology for a one-year horizon, the temporary component of credit risk—reflecting current cyclical economic conditions—often receives more weight. This is because short-term assessments must be highly sensitive to the immediate environment. Consequently, the resulting rating provides a more accurate reflection of the borrower's risk over the specified near-term period compared to long-term views.

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financial difficulties for a supplier (Company Alpha) under the Large Exposure Framework guidelines if Alpha derives 50% or more of its gross receipts from Beta?

(A) Alpha and Beta share the same primary source for non-bank funding.
(B) Alpha holds a significant proportion of Beta's total equity capital.
(C) Beta has a controlling influence over Alpha's internal dividend policy.
(D) The 50% threshold for gross receipts establishes economic dependence.

May/June 2013

12. If a bank's credit portfolio were suddenly subjected to severe geopolitical risks of an ongoing war, which type of risk is the portfolio primarily facing regardless of its regional or sectoral distribution?

(A) Idiosyncratic risk
(B) Diversifiable risk
(C) Systematic risk
(D) Non-systematic correlation risk

Oct/Nov 2015

13. If a bank funds a majority of its long-term credit assets through short-term institutional deposits and inter-bank borrowings, what is the primary cause of the maturity risk evident in the portfolio?

(A) Short-term deposits and borrowings fund a majority of long-term credit assets.
(B) The collateral offered is limited to project receivables.
(C) All obligors in the credit portfolio are located within a single country.
(D) The bank relies excessively on retail deposits for long-term lending.

May/June 2020

14. During the late 1980s and early 1990s, Japanese banks faced a severe crisis due to over-reliance on a specific type of collateral. What was this collateral?

(A) Unsecured corporate bonds
(B) Precious metals and commodities
(C) Real estate
(D) Foreign exchange derivatives

Oct/Nov 2005

15. Consider the following statements regarding the assessment of connectedness based on control:

I Control of a majority of voting rights pursuant to an agreement with other shareholders.
II Significant influence on the appointment or dismissal of an entity's administrative, managerial, or supervisory body.
III Significant influence on senior management to decide on crucial transactions such as transfer of profit or loss.

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

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May/June 2017

16. The declining profitability of traditional credit products implies little room for error in transaction selection and pricing. In this context, what factors increasingly mean the difference between profit and loss for portfolio decisions?

(A) Diversification and timing effects
(B) Collateral liquidation and guarantee invocation
(C) Binary classification and static holding
(D) Systematic and unavoidable idiosyncratic risks

Oct/Nov 2024

17. Match the exposure limit entity under the Large Exposure Framework in List I with its corresponding statutory limit in List II and select the correct option.

List I: (Exposure Limit Entity)
P. Single Counterparty standard limit
Q. Additional board-allowed exposure limit
R. Groups of Connected Counterparties
S. Interbank exposures

List II: (Statutory Limit)
1. 5% of available eligible capital base
2. 20% of available eligible capital base
3. 25% of Tier 1 capital
4. 25% of available eligible capital base

(A) P-2, Q-1, R-4, S-3
(B) P-4, Q-2, R-1, S-3
(C) P-2, Q-4, R-3, S-1

act as a burden on lenders.
Reason (R): Haircuts require the bank to forgo a portion of the collateral value, hurting profitability and eating into the capital base of the bank.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2005

57. Which of the following accurately describes the relationship between the furniture industry and the construction activity in the economy?
(A) The industry is positively correlated to construction activity.
(B) The industries are disconnected, eliminating correlation risk.
(C) The industry is negatively correlated to construction activity.
(D) The industry acts as a natural hedge against construction trends.

May/June 2017

58. Arrange the following historical financial events/crises in the correct chronological sequence:
I Protracted weakness of major American banks due to LDC credits
II Japanese banks facing real estate collateral crisis
III Far East Asian businesses crisis due to foreign currency loans
IV Northern Rock Bank funding crisis
(A) (I), (II), (III), (IV)
(B) (II), (I), (III), (IV)
(C) (I), (III), (II), (IV)
(D) (III), (I), (II), (IV)

Oct/Nov 2024

59. If permitted offsetting under the Large Exposure Framework (LEF) leaves a bank with a net short position, how is this net exposure treated for the purpose of the framework?
(A) It is treated as an intra-day interbank exposure.
(B) It is aggregated with the banking book exposures.
(C) This net exposure need not be considered as an exposure.
(D) It is converted using a CCF of 10%.

May/June 2010

60. What do financial correlations measure in the context of portfolio credit risk?
(A) The isolated probability of default of a single specific obligor.
(B) The relationship between changes in financial variables over time.
(C) The ratio of bank deposit tenors to long-term credit asset tenors.
(D) The net exposure after applying all eligible risk mitigation tools.

Oct/Nov 2011

61. In stressed circumstances, how might the regulator handle a breach of an interbank limit ex post?
(A) It will immediately revoke the bank's operational license for regulatory breach.
(B) It will automatically force the bank into standard insolvency legal proceedings.
(C) It may accept a breach to help ensure overall stability in the interbank market.
(D) It requires the bank to immediately liquidate all its interbank credit exposures.

May/June 2009

62. Consider the following factors that drive the shift towards measuring credit risk at the portfolio level rather than solely at the transaction level:
I Increased liquidity in the secondary loan market.
II Rising profitability of traditional credit products allowing high margins for error.
III Availability of credit derivatives and third-party guarantees.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2019

63. If a bank recognizes unfunded credit protection under the Large Exposure Framework (LEF),

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III All exempted exposures (except intraday inter-bank) equal to or above 10% of eligible capital.
IV Twenty largest exposures included in the scope of application, irrespective of values relative to eligible capital base.

Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2016

25. In a credit portfolio where the two largest customers account for 30% of the total exposure, which specific type of concentration risk is clearly evident?
(A) Sectoral concentration risk
(B) Group exposure concentration risk
(C) Maturity concentration risk
(D) Foreign currency concentration risk

May/June 2018

26. In the context of evaluating a bank's credit portfolio, what underlying statistical concept accounts for the significant impact on the portfolio risk level when moving from a highly concentrated portfolio to one distributed among ten unrelated industries?
(A) Standard deviation of single-asset collateral values
(B) Linear amortization of individual loan amounts
(C) Absolute probability of default for each isolated obligor
(D) Covariance or correlation of individual credit risks

Oct/Nov 2022

27. Read the following statements regarding the criteria for deeming two or more persons as a group of connected counterparties and select the correct option:
I A control relationship exists if financial problems of the controlling entity could weaken the controlled entity.
II Economic interdependence exists if the funding or repayment difficulties of one counterparty are likely to cause similar difficulties for the other.
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2005

28. Why does the furniture industry witness sharp growth during a booming residential or commercial construction market and suffer during a construction downturn?
(A) It is positively correlated to construction activity.
(B) It is negatively correlated to construction activity.
(C) It is immune to economic cycles affecting the construction sector.
(D) It acts as a substitute for the construction sector.

Oct/Nov 2010

29. Under the Large Exposure Framework (LEF), exposures to several entities are exempted from exposure limits. Which of the following is NOT an exempted exposure?
(A) Exposures to the central bank
(B) Intra-day interbank exposures
(C) Exposures to Public Sector Undertakings (PSUs) lacking government guarantee
(D) Rural Infrastructure Development Fund (RIDF) deposits placed with designated development banks

May/June 2021

30. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option.
Assertion (A): Managing tenor mismatches is a vital function with liquidity implications for banks.
Reason (R): In a bank, asset tenors vary from a few days up to 15-20 years, while deposit tenors are relatively shorter, usually up to five years.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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(D) P-3, Q-1, R-2, S-4

May/June 2010

18. Credit concentration risk rises in banks due to various factors. Which of the following is NOT explicitly a reason for the rise of credit concentration risk?
(A) Strict regulatory requirements mandating exposure to specific niche sectors
(B) Specialization incentive to become a market leader in a certain economic activity
(C) Economies of scale achieved by lowering transaction costs through focused efforts
(D) Scope for higher profit when a rapidly increasing economic activity emerges

Oct/Nov 2011

19. Read the following statements regarding the scope of application of the Large Exposure Framework (LEF) and select the correct option:
I Banks must apply LEF at the consolidated (Group) level.
II Banks must apply LEF at the Solo level.
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2009

20. The funding risk faced by Northern Rock Bank in the UK during 2007 was primarily characterized by its heavy reliance on which source of funds?
(A) Short-term institutional and non-retail borrowing in capital markets.
(B) Retail deposits gathered exclusively from individual customers.
(C) Long-term sovereign bonds issued by the domestic government.
(D) Equity capital injected by the central bank during a crisis.

Oct/Nov 2019

21. Referring to the scenario where Company Alpha has guaranteed a bank loan for Company Beta, if Company Beta fails to repay its loan and the guarantee provided by Alpha is invoked, what must the bank evaluate to assess the validity of this interconnection?
(A) The specific number of board members shared between Company Alpha and Beta.
(B) The exact percentage of Alpha's voting rights owned by Company Beta.
(C) Alpha's capacity to honour the claim via its net worth and liquid assets.
(D) Whether Beta can find an alternate supplier for its intermediate components.

May/June 2025

22. How is unsystematic or idiosyncratic risk described within the context of a fine-grained portfolio?
(A) It is the risk that affects the entire economic environment and all market participants simultaneously.
(B) It represents firm-specific risks that are largely diversified away as individual exposures decrease.
(C) It is an unavoidable risk that varies in intensity but touches every entity within a given market.
(D) It is a risk driven entirely by broad macroeconomic fluctuations and financial market conditions.

Oct/Nov 2007

23. What is the primary comfort offered by a credit portfolio covering a wide geographical area rather than building up assets in a particular region?
(A) It completely eliminates the bank's requirement for issuing any foreign currency denominated loans.
(B) It removes all systematic risk associated with sudden global macroeconomic downturns or recessions.
(C) It aligns the maturities of regional assets perfectly with local retail deposit tenors and flows.
(D) It ensures that local economic vagaries do not significantly impact the overall credit portfolio.

May/June 2014

24. Consider the following statements regarding the reporting requirements for Large Exposures to the regulator:
I All exposures equal to or above 10% of the bank's eligible capital.
II All other exposures without the effect of credit risk mitigation equal to or above 10% of eligible capital.

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Oct/Nov 2018

37. Which of the following is NOT an explicitly stated criterion for establishing economic interdependence under the Large Exposure Framework?

(A) One entity owns exactly 40% of the voting rights of the other entity without any other agreements.

(B) One counterparty guarantees the exposure of the other, and the guarantor is likely to default if a claim occurs.

(C) A significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced.

(D) Two counterparties rely on the same expected source of funds to repay loans, with no other independent source of income.

May/June 2023

38. When considering sector correlation, which of the following represents the most appropriate choice for constructing a credit portfolio, assuming obligor credit risks are satisfactory?

(A) Sectors having highly positive correlation

(B) Sectors with zero structural dependencies

(C) Sectors heavily dependent on the same supply chains

(D) Sectors having negative correlation

Oct/Nov 2009

39. Consider the following parameters regarding the Large Exposure Framework (LEF) and associated risks:

I A large exposure is defined at equal to or above 10% of Tier 1 capital.

II Control relationship requires only a 20% ownership of voting rights.

III Economic interdependence includes the likelihood of one entity encountering funding difficulties if the other does.

IV Systematic risk represents risks peculiar to individual firms.

Which of the above statement(s) is/are correct?

(A) (I) and (III) only

(B) (I), (II), and (III)

(C) (II) and (IV) only

(D) (I), (III), and (IV)

NODIA

May/June 2016

40. Read the following statements regarding the offsetting of positions across different issues or books and select the correct option:

I Positions may be offset only when the short position is junior to the long position, or if they are of the same seniority.

II Netting short positions in the trading book against long positions in the banking book is completely permitted.

(A) Only (I)

(B) Only (II)

(C) Both (I) and (II)

(D) Neither (I) nor (II)

Oct/Nov 2020

41. According to standard capital regulations, is a maturity mismatch recognized as an eligible credit risk mitigation technique if the original maturity of the hedge is 18 months and the residual maturity is 4 months?

(A) No, because any form of maturity mismatch invalidates the use of credit risk mitigation.

(B) Yes, as original maturity exceeds one year and residual maturity is at least three months.

(C) No, because the residual maturity for such instruments must be greater than six months.

(D) Yes, because the original maturity for such hedges must be strictly less than two years.

May/June 2022

42. Which statement regarding the calculation of exposure value for Trading Book positions is incorrect?

(A) A bank must add trading book exposures to banking book exposures for the same counterparty.

(B) The exposure value of straight debt instruments will be equal to their market value.

(C) Concentrations in a particular commodity or currency are strictly governed by the Large Exposure Framework limit.

(D) Instruments such as swaps and futures must be converted into positions following risk-based capital requirements.

Oct/Nov 2006

31. Under the Large Exposure Framework, which of the following statements correctly identifies how the exposure value for a simple short put option is calculated?

(A) It is based solely on its market value.
(B) It is equal to the strike price of the option plus its market value.
(C) It is equal to the strike price of the option minus its market value.
(D) It is treated as a negative exposure and converted to a CCF of 10%.

May/June 2019

32. Read the following scenario and answer the question that follows:
Delta Bank holds both long and short positions in the trading book. The bank has a long position in a senior corporate bond issued by Omega Corp and a short position in a subordinated debt (junior) bond issued by the same Omega Corp. Both bonds share identical coupon rates and maturity dates. The bank also seeks to offset short positions in the trading book against long positions in the banking book.
Under the Large Exposure Framework rules for offsetting between long and short positions in different issues, can the bank offset these two Omega Corp positions?

(A) No, because offsetting is never allowed across different issues.
(B) Yes, because the short position is junior to the long position.
(C) No, because the short position must be senior to the long position.
(D) Yes, but only if they are classified in the "Equity" bucket.

Oct/Nov 2014

33. Identify the correct pair regarding Eligible Credit Risk Mitigation (CRM) techniques under the Large Exposure Framework.

(A) Standardized Approach - Internal-Ratings based collateral (receivables) are eligible
(B) Unfunded credit protection - Recognized amount is the value of the protected portion
(C) Maturity mismatch in CRM - Recognized if residual maturity of hedge is less than three months
(D) On-balance sheet netting - Strictly prohibited for calculating exposure values

May/June 2012

34. Match the regulatory condition in List I with its corresponding percentage under the Large Exposure Framework in List II and select the correct option.

List I: (Regulatory Condition)
P. Single Counterparty standard limit
Q. Group of connected counterparties limit
R. Threshold defining a "Large Exposure"
S. Exceptional board-allowed additional exposure

List II: (Regulatory Percentage)
1. 10%
2. 20%
3. 25%
4. 5%

(A) P-1, Q-4, R-2, S-3
(B) P-3, Q-1, R-4, S-2
(C) P-4, Q-2, R-3, S-1
(D) P-2, Q-3, R-1, S-4

Oct/Nov 2025

35. Which of the following is NOT listed as an immediate or incremental strategy for mitigating concentration risk?

(A) Selling whole-loan sales on a recourse basis to increase exposures
(B) Tightening constraints on special mention or nonperforming levels
(C) Obtaining guarantees from Export-Import banks or credit guarantee corporations
(D) Executing exit strategies from lower-quality relationships

May/June 2007

36. Arrange the following regulatory guidance/ framework issuance events in chronological order:

I Issuance of a national Large Exposure Framework circular
II BCBS issued Standards on 'Supervisory framework for measuring and controlling large exposures'
III BCBS issued supervisory guidance on Measuring and Controlling Large Credit Exposures

(A) (III), (II), (I)
(B) (I), (II), (III)
(C) (II), (III), (I)
(D) (III), (I), (II)

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(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2017

49. Under the Large Exposure Framework (LEF) guidelines, can a bank offset its trading book short positions against its banking book long positions?
(A) Netting across banking and trading books is not permitted.
(B) Yes, if they belong to the same specific counterparty name.
(C) Yes, provided the central regulator grants unique approval.
(D) No, unless the net exposure equals zero after adjustments.

May/June 2006

50. Historical evidence shows that credit risk correlation varies over business cycles. When does the credit risk correlation typically become higher?
(A) During periods of sharp economic growth
(B) When the central bank lowers interest rates
(C) During economic recessions
(D) When systemic risk is completely eliminated

Oct/Nov 2008

51. Read the following scenario and answer the question that follows:
A bank has an exposure to a sovereign-exempted entity, which is fully hedged by a credit derivative provided by a financial corporation. The credit derivative involves a maturity mismatch, where the original maturity of the hedge is 18 months, and the residual maturity is 4 months.
How should the bank treat the exposure to the exempted entity under the Large Exposure Framework guidelines?
(A) It remains fully exempted because the original entity is sovereign.
(B) It is disregarded as the hedge possesses a maturity mismatch.
(C) It is added to the bank's interbank intraday exposure limit.
(D) It is treated as an exposure to the financial corporation providing the hedge.

May/June 2024

52. In the case of credit derivatives that represent sold protection, how is the exposure calculated?
(A) The nominal amount of the referenced name plus the credit protection value.
(B) The market value of the derivative contract as per accounting standards.
(C) A value of zero since the protection has been sold to another counterparty.
(D) Sum due if the reference entity triggers, less credit protection value.

Oct/Nov 2021

53. Identify the correct pair matching the concentration risk mitigation strategy to its corresponding action.
(A) Modifying underwriting standards by selling loans on a nonrecourse basis.
(B) Altering exposure limits by obtaining insurance from guarantee corporations.
(C) Booking transactions with performance patterns unlike the existing portfolio.
(D) Buying credit derivative protection to hold additional regulatory capital.

May/June 2013

54. The risk of a credit portfolio due to unexpected changes in macroeconomic and financial market conditions on the performance of the borrower is best described as:
(A) Unsystematic risk
(B) Idiosyncratic risk
(C) Systematic risk
(D) Diversification risk

Oct/Nov 2015

55. Identify the incorrect pair regarding correlation risk and sector sensitivity.
(A) Default correlation – Remains low as credit quality deteriorates.
(B) Non-cyclical sectors – Display lower correlation to the downturn.
(C) Cyclical sectors – Specifically include real estate construction.
(D) Default correlation – Irrelevant if obligor risk is extremely low.

May/June 2020

56. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option.
Assertion (A): Haircuts applied to financial collateral under the comprehensive approach

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(C) They are subject to a standard 10% supervisory haircut.
(D) They are converted using CCFs with a floor of 20%.

Oct/Nov 2022

69. Identify the incorrect statement regarding systematic risk.
(A) It represents the effect of unexpected changes in macroeconomic conditions.
(B) It only affects non-cyclical industries and can be totally diversifiable.
(C) It is unavoidable and beyond the control of any individual firm.
(D) It infects the credit portfolio particularly when a large number of borrowal accounts become non-performing assets.

May/June 2005

70. Consider the following statements representing the foundational concepts of portfolio credit risk:
I Systematic risk of a credit portfolio represents the effect of unexpected changes in macroeconomic conditions.
II Large exposure is defined if it is equal to or above 10% of the bank's eligible capital base.
III Unsystematic risk represents risks peculiar to individual firms, such as mismanagement.
IV Financial correlations measure the relationship between changes of two or more variables over time.
V Economic interdependence only exists if one counterparty owns more than 50% of the other's voting rights.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (IV)
(B) (I), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (IV), and (V)

NODIA

by what amount is the value of the exposure to the counterparty reduced?
(A) The value of the collateral adjusted after applying supervisory haircuts
(B) Zero, since unfunded credit protection is not eligible under LEF
(C) The value of the protected portion
(D) The nominal value minus the Tier 1 capital base

May/June 2025

64. Consider the following statements regarding the exposure values of options under the Large Exposure Framework:
I The exposure value for a simple long call option is its market value.
II The exposure value for a short put option is equal to the strike price minus its market value.
III In the case of short call or long put options, a default of the underlying leads to a profit.
IV After aggregation, negative net exposures shall be treated as zero.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2007

65. Match the reason for the rise of credit concentration risk in banks in List I with its corresponding explanation in List II and select the correct option.
List I: (Reason for Credit Concentration Risk)
P. Specialization incentive
Q. Economies of scale
R. Scope for higher profit
S. External reasons
List II: (Explanation)
1. Transaction cost comes down as exposure to a firm or sector increases
2. Rapidly increasing economic activity yields higher than average profits
3. Operating in a small-size market restricts diversification
4. Aiming to become a leader in a specific market area
(A) P-1, Q-4, R-3, S-2
(B) P-4, Q-1, R-2, S-3
(C) P-3, Q-2, R-1, S-4
(D) P-2, Q-3, R-4, S-1

May/June 2014

66. Which of the following is incorrectly paired as evidence of a control relationship between counterparties?
(A) Voting agreements – Control over a majority of the entity's voting rights.
(B) Senior management – Power to direct transactions like the transfer of profits.
(C) Administrative body – Right to remove a majority of board or council members.
(D) Ownership – Holding 20% of voting rights automatically satisfies control.

Oct/Nov 2016

67. In establishing connectedness based on economic interdependence, consider the following criteria:
I 50% or more of one counterparty's gross receipts is derived from the other.
II One counterparty has fully guaranteed the exposure of the other, making default likely if invoked.
III A significant part of production is sold to another counterparty and cannot easily be replaced.
IV Financial problems of one counterparty would cause full repayment difficulties for the other.
V Insolvency of one counterparty is likely to be associated with the insolvency of the other.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (IV) only
(B) (II), (III), (IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

May/June 2018

68. Forms of collaterals like commercial and residential real estate that are only eligible under the Internal-Ratings Based (IRB) Approach have what status for Large Exposure Framework purposes?
(A) They are not eligible to reduce exposure values.
(B) They are fully eligible to reduce exposure values.

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Oct/Nov 2023

43. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option.

Assertion (A): As the obligor credit risk deteriorates, sector diversification provides minimal protection, and the risk of default becomes higher.

Reason (R): Default correlation is high as the credit rating approaches lower quality, making sector correlation irrelevant.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2011

44. Consider the following strategies for managing concentration risk in a credit portfolio:

I Increasing pricing or tightening terms for lower-quality relationships.
II Relying entirely on identical collateral types for all new credit assets.
III Booking transactions relatively immune to changes in the economic cycle.
IV Buying total return swaps on individual transactions or a pool.
V Adjusting limits on commitment or outstanding amounts.

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (V)
(B) (I), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (IV), and (V)

Oct/Nov 2012

45. Which statement concerning collateral risk at the portfolio level is incorrect?

(A) A sharp fall in the property market can erode the comfort of a portfolio heavily secured by real estate.
(B) The sub-prime crisis in the US was significantly driven by concentrated collateral risks.
(C) Accepting collaterals of the same type across the portfolio mitigates overall credit risk perfectly.
(D) Japanese banks discovered that liquidation of collaterals was insufficient to cover even interest obligations during a recession.

May/June 2015

46. Match the type of exposure in List I with its definition under the Large Exposure Framework in List II and select the correct option.

List I: (Type of Exposure)

P. Banking book on-balance sheet non-derivative assets
Q. OTC derivatives
R. Securities financing transactions (SFTs)
S. Banking book "traditional" off-balance sheet commitments

List II: (Definition under Large Exposure Framework)

1. Converted to credit equivalents using CCFs with a floor of 10%
2. Determined as per extant guidelines on exposure at default
3. Exposure value defined as accounting value net of specific provisions
4. Uses the method currently used for risk-based capital requirements

(A) P-1, Q-3, R-2, S-4
(B) P-3, Q-2, R-4, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-2, Q-4, R-1, S-3

Oct/Nov 2013

47. Which of the following is NOT considered a diversifiable risk?

(A) Industry risk
(B) Recession
(C) Maturity risk
(D) Collateral risk

May/June 2008

48. Consider the following conditions regarding the offsetting of long and short positions in the trading book for the same counterparty:

I Identical issuer
II Identical coupon and currency
III Identical maturity

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (II) and (III) only

NODIA

ANSWERS

1. (D) P-2, Q-1, R-4, S-3
Diversifiable risk in credit portfolios encompasses various categories including concentration, correlation, and portfolio funding risks. Concentration risk is subdivided into geographical locations, regions, countries, and specific collateral types. Correlation risk involves further sub-categories like sector and default correlation. Funding risk stands as a distinct branch, while diversifiable risk serves as the overarching classification for these risk components.

2. (C) Total exposure to a counterparty equal to or above 10% of the Tier 1 capital base.
Large exposure frameworks define specific thresholds to identify significant concentrations of risk within a bank. A large exposure is officially recognized when the total exposure to a single counterparty or a group of connected counterparties reaches or exceeds ten percent of the bank's eligible Tier 1 capital base. This measurement ensures systemic stability through focused regulatory monitoring.

3. (C) All 500 customers are concentrated in the same region or locality.
Portfolio credit risk increases significantly when exposures are concentrated within a single region or locality. Geographic concentration prevents the bank from benefiting from diversification, making the entire portfolio vulnerable to local economic downturns. Distributing loans across multiple unrelated industries and regions effectively reduces this risk by ensuring localized financial failures do not destabilize the bank's total credit assets.

4. (C) Tier 1 capital only
Regulatory frameworks for large exposures require banks to calculate limits based on a stable capital foundation. The eligible capital base for these calculations is strictly defined as the Tier 1 capital, as reflected in the most recent audited balance sheet. This ensures that large credit concentrations are supported by the highest quality capital available to the financial institution.

5. (B) Interest rate hikes by central banks shift forex flows, putting pressure on domestic currency values.
Foreign currency concentration risk becomes prominent when domestic economic shifts occur. Interest rate hikes by global central banks often shift foreign exchange flows, which puts significant pressure on the valuation of domestic currencies. This volatility affects businesses with foreign currency liabilities, increasing their credit risk and potential for default, thereby impacting the bank's overall credit portfolio stability.

6. (B) Economic interdependence via gross receipts and loan guarantees.
Two entities are considered connected counterparties when economic interdependence is established through specific business relationships. In this case, the high percentage of gross receipts derived from transactions and the provision of a full loan guarantee create a situation where the financial failure of one likely leads to the failure of the other, requiring joint regulatory exposure limits.

7. (B) All credits can potentially become bad over time given a particular economic scenario.
Modern credit risk management recognizes that a binary classification of credits is insufficient. Under certain economic scenarios, all credits possess the inherent potential to deteriorate. Measuring risk at the portfolio level allows banks to account for these shifts and the impact of secondary markets, moving away from static views toward proactive management of all credit exposures over time.

8. (A) 10% to 15%
Prudent banking policies suggest limiting exposure to any single economic sector to mitigate the impact of sectoral downturns. While infrastructure is a vital sector, concentrating too much capital there increases

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vulnerability. Ideally, sectoral concentration should be maintained between ten percent and fifteen percent of the total credit portfolio to balance growth opportunities with effective risk management and diversification.

9. (B) It is treated as an exposure to the counterparty providing the credit protection.
When a bank hedges an exposure to an exempted entity using a credit derivative, the risk profile shifts from the original counterparty to the protection provider. Consequently, the framework treats this as an exposure to the entity providing the credit protection. This ensures that the risk associated with the derivative contract is captured within the bank's concentration limits.

10. (C) Assertion (A) is true, but Reason (R) is false.
Excessive exposure to specific sectors like construction during boom periods creates significant risk during subsequent downturns. However, business cycles do not affect all sectors uniformly. Different industries have varying sensitivities to economic shifts, meaning the reason for vulnerability is not uniform sectoral sensitivity but the specific cyclical nature of construction, which makes the stated reason for the assertion incorrect.

11. (D) The 50% threshold for gross receipts establishes economic dependence.
Economic dependence is a critical factor in identifying connected counterparties under regulatory frameworks. When one entity derives fifty percent or more of its gross receipts from transactions with another, it creates a situation where the financial health of the supplier is tied to the buyer. A reduction in orders from the dominant buyer would likely cause significant distress.

12. (C) Systematic risk
Systematic risk represents the impact of broad macroeconomic or geopolitical events that affect all market participants simultaneously. Geopolitical crises, such as ongoing wars, influence the entire economic environment, making it impossible to avoid through simple regional or sectoral diversification. Unlike idiosyncratic risks which are firm-specific, systematic risks are inherent to the entire market and affect all portfolio assets.

13. (A) Short-term deposits and borrowings fund a majority of long-term credit assets.
Maturity risk arises when there is a significant mismatch between the tenors of a bank's assets and liabilities. Funding long-term credit assets with short-term institutional deposits and inter-bank borrowings creates a liquidity strain. This imbalance means the bank must constantly roll over its funding, exposing it to the risk that market conditions might change before assets mature.

14. (C) Real estate
Historical financial crises highlight the dangers of collateral concentration. During the late 1980s and early 1990s, Japanese banks relied heavily on real estate as collateral for loans. When the real estate bubble burst, the values of these properties plummeted, leaving banks with insufficient security to cover their outstanding credits, which led to a prolonged systemic banking crisis.

15. (D) (I), (II), and (III)
Establishing a control relationship between entities involves several factors including voting rights and management influence. Criteria include holding a majority of voting rights through shareholder agreements and having the power to appoint or dismiss administrative or managerial bodies. Additionally, exercising significant influence over senior management regarding crucial financial transactions like profit transfers confirms a control relationship between counterparties for regulatory purposes.

16. (A) Diversification and timing effects
Declining profitability in traditional credit products necessitates a more sophisticated approach to risk management. Decisions must move beyond simple binary classifications of credits. Factors such as diversification and the timing of market entries or exits are now primary determinants of profit or loss, as they help banks navigate tight margins and maximize risk-adjusted returns effectively in volatile markets.

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17. (A) P-2, Q-1, R-4, S-3
The Large Exposure Framework sets specific limits to manage concentration risk. A single counterparty is generally limited to twenty percent of the capital base, while groups of connected counterparties can reach twenty-five percent. Exceptional board-approved exposures allow an additional five percent, and interbank exposures are also capped at twenty-five percent of Tier 1 capital to ensure stability.

18. (A) Strict regulatory requirements mandating exposure to specific niche sectors
Banks often increase credit concentration due to specialization incentives, aiming for market leadership in specific sectors. Economies of scale and higher profit potential in rapidly growing activities also drive concentration. However, strict regulatory requirements usually focus on limiting concentration rather than mandating exposure to niche sectors, making such mandates an unlikely cause for the rise of concentration risk.

19. (C) Both (I) and (II)
Regulatory standards require the Large Exposure Framework to be applied comprehensively across banking operations. This means institutions must monitor and report their exposures at both the solo level, covering the individual bank, and the consolidated group level, which includes all subsidiaries. This dual application ensures that concentrations are managed effectively across the entire organizational structure to prevent systemic failures.

20. (A) Short-term institutional and non-retail borrowing in capital markets.
The collapse of Northern Rock in 2007 demonstrated the dangers of funding concentration. The bank relied heavily on short-term institutional and non-retail borrowing in capital markets to fund its long-term mortgage lending. When these markets froze during the financial crisis, the bank could not refinance its liabilities, leading to a liquidity crisis that required significant government intervention.

21. (C) Alpha's capacity to honour the claim via its net worth and liquid assets.
When a guarantee is provided by one company for another's bank loan, the bank must assess the guarantor's ability to fulfill that obligation. If the guarantee is invoked, the guarantor must have sufficient net worth and liquid assets to honor the claim. This assessment is essential to determine if the entities are economically linked through a valid financial guarantee.

22. (B) It represents firm-specific risks that are largely diversified away as individual exposures decrease.
Unsystematic or idiosyncratic risk refers to hazards specific to individual firms or narrow industries, such as poor management or local disruptions. In a fine-grained portfolio with many small, independent exposures, these risks tend to cancel each other out through diversification. As the number of individual exposures increases, the impact of any single firm's failure on the total portfolio diminishes.

23. (D) It ensures that local economic vagaries do not significantly impact the overall credit portfolio.
Geographical diversification provides a significant buffer against localized economic shocks. By maintaining a credit portfolio across a wide area instead of a single region, a bank ensures that economic downturns or disasters in one specific locality do not severely impact its overall financial health. This strategy reduces the correlation between individual credit assets, stabilizing the bank's long-term performance.

24. (D) (I), (II), (III), and (IV)
Reporting requirements under the Large Exposure Framework are comprehensive to ensure transparency and oversight. Banks must report exposures exceeding ten percent of their eligible capital, regardless of whether they are exempted or have credit risk mitigation applied. Additionally, they must report their twenty largest exposures, ensuring the regulator has a clear view of the bank's most significant credit concentrations.

25. (B) Group exposure concentration risk
Group exposure concentration risk occurs when a substantial portion of a bank's total credit is

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tied to a small number of counterparties. When two customers account for thirty percent of a one-billion-rupee portfolio, the bank is highly vulnerable to the financial health of those specific entities. This concentration exceeds prudent limits and represents a significant risk to the bank's stability.

26. (D) Covariance or correlation of individual credit risks
Statistical concepts like covariance and correlation explain the impact of diversification on portfolio risk. When a portfolio is concentrated in one area, individual credit risks are highly correlated, meaning they are likely to fail together. Distributing assets among unrelated industries reduces this correlation, which lowers the overall standard deviation and risk level of the entire credit portfolio significantly.

27. (C) Both (I) and (II)
Connected counterparties are identified through control relationships or economic interdependence. A control relationship exists when one entity's problems weaken another through shared ownership or influence. Economic interdependence occurs when the financial distress of one counterparty is likely to cause similar difficulties for another. Both criteria ensure that the regulator treats these separate legal entities as a single risk exposure.

28. (A) It is positively correlated to construction activity.
Certain industries exhibit high positive correlation because their success depends on the same economic drivers. The furniture industry is closely tied to residential and commercial construction; as more buildings are completed, demand for furniture rises. Conversely, a slump in construction leads to fewer furniture sales. This dependency makes the performance of the furniture sector mirror trends in the construction market.

29. (C) Exposures to Public Sector Undertakings (PSUs) lacking government guarantee
The Large Exposure Framework exempts specific low-risk or mandated exposures from standard limits, such as those to central banks or intraday interbank exposures. Deposits in the Rural Infrastructure Development Fund are also typically excluded. However, exposures to Public Sector Undertakings that do not carry a government guarantee are treated as commercial risks and remain subject to standard concentration limits.

30. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Banks must carefully manage tenor mismatches because they have direct implications for institutional liquidity. Most bank deposits are short-term, generally up to five years, while credit assets like home or infrastructure loans can last for fifteen to twenty years. This structural imbalance requires active management to ensure that the bank can meet its withdrawal obligations while maintaining its long-term assets.

31. (C) It is equal to the strike price of the option minus its market value.
Calculating exposure values for derivative instruments requires specific methodologies. For a simple short put option, the exposure value is determined by taking the strike price of the option and subtracting its current market value. This approach captures the potential loss the bank might face if the option is exercised, ensuring that the exposure is accurately reflected in concentration limits.

NODIA

32. (B) Yes, because the short position is junior to the long position.
Offsetting long and short positions in the trading book is permitted under specific conditions regarding seniority. A bank can offset a long position in a senior bond with a short position in a subordinated debt instrument issued by the same entity. Because the short position is junior to the long position, the regulatory framework allows for this net exposure calculation.

33. (B) Unfunded credit protection - Recognized amount is the value of the protected portion
Credit risk mitigation techniques allow banks to reduce their reported exposure values through funded or unfunded protection. For unfunded credit protection, the recognized amount for regulatory purposes is the value of the protected portion of the exposure. This adjustment helps

banks manage their concentration limits while still accounting for the residual risk associated with the protection provider or guarantor.

34. (D) P-2, Q-3, R-1, S-4
The Large Exposure Framework utilizes specific percentages to define and limit concentrations. The standard limit for a single counterparty is twenty percent, while groups are limited to twenty-five percent of Tier 1 capital. A large exposure is triggered at ten percent, and boards may allow an additional five percent in exceptional cases. These percentages provide a clear structure.

35. (A) Selling whole-loan sales on a recourse basis to increase exposures
Banks use various strategies to mitigate concentration risk, such as tightening terms for low-quality borrowers or obtaining guarantees. They may also execute exit strategies for risky relationships. However, selling whole loans on a recourse basis is not a mitigation strategy; instead, it increases exposure because the bank remains liable for the loans if the borrower defaults on the debt.

36. (A) (III), (II), (I)
The development of large exposure regulations followed a specific chronological sequence starting with global standards. The Basel Committee on Banking Supervision first issued supervisory guidance on measuring credit exposures. This was followed by the formal issuance of standards for controlling large exposures. Finally, national regulators issued circulars to implement these international standards within their specific domestic banking jurisdictions.

37. (A) One entity owns exactly 40% of the voting rights of the other entity without any other agreements.
Economic interdependence is established through significant business ties, such as guarantees or reliance on a single buyer for over half of gross receipts. Shared funding sources also create interdependence. However, owning exactly forty percent of an entity's voting rights without any additional agreements or control mechanisms does not meet the standard regulatory criteria for establishing economic interdependence between counterparties.

NODIA

38. (D) Sectors having negative correlation
Constructing a robust credit portfolio requires selecting sectors that do not move in tandem. Choosing sectors with negative correlation is the most effective way to diversify, as a downturn in one industry may be offset by stability or growth in another. This approach minimizes the likelihood of simultaneous defaults across the portfolio, ensuring better protection against systemic or economic shocks.

39. (A) (I) and (III) only
Large exposures are defined when they reach ten percent of Tier 1 capital. Economic interdependence is also a key factor, occurring when the funding difficulties of one entity likely affect another. While systematic risk affects the whole market, the control relationship typically requires higher ownership or specific management influence. Therefore, only definitions regarding the large exposure threshold and interdependence are correct.

40. (A) Only (I)
Regulatory rules for offsetting positions require that the short position be junior to or of the same seniority as the long position. This ensures that the bank's net exposure is not understated. Furthermore, the framework strictly prohibits netting short positions held in the trading book against long positions in the banking book, maintaining a clear separation between these two distinct portfolios.

41. (B) Yes, as original maturity exceeds one year and residual maturity is at least three months.
Maturity mismatches in credit risk mitigation are recognized only if the hedge meets specific tenor requirements. For the mitigation to be eligible, the original maturity of the hedge must exceed one year, and the residual maturity must be at least three months. Since the hedge in question has an eighteen-month original and four-month residual maturity, it remains an eligible technique.

CHAPTER 10
Credit Risk Models

May/June 2013

1. Why might credit models be utilized to establish a "common credit language" by underwriters?

(A) To manually override automated decisions specifically for consumer lending operations in retail banking environments.

(B) To determine the precise physical value of the collateral backing large commercial loans for risk mitigation.

(C) To ensure that heuristic evaluations are uniform across all global banking institutions and regulatory bodies.

(D) To select assets from a pool to construct an Oct/Nov 2018-acceptable portfolio or obtain a credit rating.

Oct/Nov 2018

2. Consider the following statements about Credit Risk Models:

I Statistical procedures can derive an objective selection of creditworthiness factors.

II The goodness of fit of a statistical model depends heavily on empirical data quality.

III Empirical evidence can strengthen the reliability of statistical models provided the data is well tested.

IV Heuristic models do not rely on the retrieval of past experiences or qualitative data.

V Structural models are built on the assumption of a firm having unlimited liability.

Which combination of statements is correct?

(A) (I), (II), and (III)
(B) (I), (II), (III), and (V)
(C) (II), (III), IV), and (V)
(D) (I), (III), (IV), and (V)

May/June 2005

3. Consider the following factors regarding the importance of credit risk modelling:

I Banks are becoming increasingly quantitative in their treatment of credit risk.

II New markets are emerging in credit derivatives and the marketability of existing loans is increasing.

III Regulators are concerned about improving the current system of bank capital requirements.

Which of the above factors correctly explain why credit risk modelling is gaining significant importance?

(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2023

4. According to Altman's Z-Score zones of discrimination, a computed Z Score of 2.45 places a firm in which specific zone?

(A) Safe Zone
(B) Grey Zone
(C) Distress Zone
(D) Default Zone

May/June 2019

5. How is a "Heuristic model" formally defined in the context of credit risk evaluation?

(A) A mathematical relationship between random and non-random variables to estimate exact default probability.

(B) A framework attempting to gain insights methodically on the basis of previous experiences and trial-and-error.

(C) A continuous classification algorithm sorting known populations into distinct groups based on volatility.

(D) A system dependent entirely on artificial neural networks for high-dimensional historical feature extraction.

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50. (C) During economic recessions
Credit risk correlation is dynamic and tends to fluctuate according to the broader economic environment. Historical data indicates that correlation between different credits increases during economic recessions. When the economy shrinks, businesses across various sectors face similar financial pressures, increasing the likelihood that they will default together. This heightened correlation reduces the effectiveness of diversification during periods of financial stress.

51. (D) It is treated as an exposure to the financial corporation providing the hedge.
Under the Large Exposure Framework, if an exposure to an exempted entity is hedged by a credit derivative, the bank must look through to the protection provider. The risk is transferred from the sovereign entity to the financial corporation providing the hedge. Therefore, the bank treats the exposure as being held against the provider, even if there is a maturity mismatch.

52. (D) Sum due if the reference entity triggers, less credit protection value.
When a bank sells credit protection via a derivative, it takes on the risk of the reference entity. The exposure value in this scenario is calculated as the sum due if the reference entity triggers a credit event, minus the value of the credit protection already received. This calculation ensures the bank's potential maximum loss is accounted for in its concentration limits.

53. (C) Booking transactions with performance patterns unlike the existing portfolio.
Effective mitigation of concentration risk involves active portfolio management. One key strategy is to book new transactions that exhibit performance patterns unlike the existing portfolio. By selecting assets with different cyclical sensitivities or correlations, the bank can achieve better diversification. This approach ensures that the total risk of the portfolio is reduced through the inclusion of non-correlated credit assets.

54. (C) Systematic risk
Systematic risk is the risk inherent to the entire market or economy, driven by unexpected changes in macroeconomic factors such as interest rates, inflation, or financial market conditions. It affects the performance of all borrowers simultaneously and cannot be diversified away. This type of risk is distinct from idiosyncratic risk, which is specific to individual firms or industries.

55. (A) Default correlation – Remains low as credit quality deteriorates.
Correlation risk is a complex component of credit portfolio management. While non-cyclical sectors show lower correlation during downturns, and default correlation is irrelevant for very high-quality obligors, it is incorrect to say default correlation remains low as credit quality deteriorates. In reality, as borrowers approach default, their performance becomes highly correlated, making simultaneous failures more likely regardless of their sector.

NODIA

56. (C) Assertion (A) is true, but Reason (R) is false.
Haircuts are applied to financial collateral to account for potential market price volatility during liquidation. While lenders might view them as a burden because they reduce the recognized value of the security, they are necessary for prudent risk management. The assertion that haircuts hurt profitability or eat into capital is misleading, as their primary purpose is to protect the bank's capital.

57. (A) The industry is positively correlated to construction activity.
Positive correlation exists between two industries when they tend to prosper or decline together. The furniture industry and construction activity share this relationship; growth in new buildings leads to increased demand for furnishings. Understanding this positive correlation is vital for banks to avoid excessive concentration, as a downturn in construction will simultaneously impact the financial health of furniture manufacturing borrowers.

42. (C) Concentrations in a particular commodity or currency are strictly governed by the Large Exposure Framework limit.
The Large Exposure Framework requires banks to aggregate trading and banking book exposures for each counterparty. Debt instruments are valued at market rates, and swaps or futures are converted based on risk-based requirements. However, concentrations in specific commodities or currencies are usually managed under separate market risk frameworks rather than being governed by the standard Large Exposure Framework limits.

43. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Sector diversification provides less protection as credit quality declines. When obligors approach default, their default correlation increases significantly, often making the initial sector correlation irrelevant. This happens because the specific financial distress of the borrowers becomes the dominant driver of default, causing multiple accounts to fail simultaneously regardless of the different sectors or industries they might originally represent.

44. (B) (I), (III), (IV), and (V)
Managing concentration risk involves various strategies such as adjusting pricing for lower-quality credits and using credit derivatives like total return swaps. Banks also adjust commitment limits and seek transactions immune to economic cycles. However, relying on identical collateral types is counterproductive, as it increases rather than decreases concentration risk. Therefore, only strategies focused on diversification and active limit management are effective.

45. (C) Accepting collaterals of the same type across the portfolio mitigates overall credit risk perfectly.
Collateral risk arises when a portfolio is heavily secured by the same type of asset, such as real estate. Sharp falls in specific markets can erode the security of many loans simultaneously, as seen in the US sub-prime crisis. Accepting the same type of collateral across a portfolio increases concentration risk rather than mitigating it, making this approach dangerous.

46. (B) P-3, Q-2, R-4, S-1
Under the Large Exposure Framework, exposure values are defined differently based on the asset type. Banking book non-derivative assets are valued at their accounting value net of provisions. Traditional off-balance sheet commitments use credit conversion factors with a ten percent floor. OTC derivatives and securities financing transactions follow methods currently used for risk-based capital requirements or exposure at default.

47. (B) Recession
Diversifiable risks are firm or industry-specific hazards that can be mitigated through a well-distributed portfolio. Examples include industry-specific downturns, maturity mismatches, and collateral concentrations. In contrast, a recession is a systematic risk that affects the entire economy simultaneously. Because it impacts all sectors and participants, it cannot be eliminated through diversification, making it a non-diversifiable risk for banks.

48. (D) (I), (II), and (III)
Offsetting long and short positions in the trading book for a single counterparty requires the positions to be nearly identical. Regulatory standards mandate that the positions must have the same issuer, currency, and coupon rate. Furthermore, the maturity dates must be identical to ensure that the risk of one position perfectly offsets the risk of the other without creating temporal gaps.

49. (A) Netting across banking and trading books is not permitted.
Banks are required to maintain a strict separation between their banking and trading books for risk management and reporting. The Large Exposure Framework does not permit the netting of short positions held in the trading book against long positions in the banking book. This rule prevents institutions from masking significant credit exposures through unrelated trading activities, ensuring accurate risk assessment.

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agreements or powers to direct management, such ownership does not satisfy criteria.

67. (D) (I), (II), (III), (IV), and (V)
Economic interdependence exists when two or more entities are so linked that financial problems of one likely lead to difficulties for others. Criteria include deriving over fifty percent of receipts from a counterparty, providing full guarantees, or having non-replaceable production ties. When insolvency in one entity is associated with insolvency in another, they must be treated as connected counterparties.

68. (A) They are not eligible to reduce exposure values.
The Large Exposure Framework recognizes only certain high-quality collateral to reduce exposure values. Forms of collateral like commercial and residential real estate, which are only eligible under the Internal-Ratings Based approach for capital requirements, are not permitted to reduce exposure values within the standard framework. This ensures a conservative measurement of large exposures by excluding more volatile collateral types.

69. (B) It only affects non-cyclical industries and can be totally diversifiable.
Systematic risk affects the entire market, not just non-cyclical industries, and cannot be diversified away. It arises from macroeconomic factors like inflation, interest rates, or recessions. Hence, saying it is limited to certain industries and fully diversifiable is wrong. The other statements correctly describe its unavoidable, economy-wide impact and its effect on credit portfolios.

70. (A) (I), (II), (III), and (IV)
Portfolio credit risk foundations include systematic risk from macroeconomic changes and idiosyncratic risk specific to individual firms. Large exposures are identified at ten percent of Tier 1 capital, and financial correlations track variable changes over time. However, economic interdependence is defined by broader financial links rather than just a fifty percent ownership threshold, making it essential to evaluate all criteria.

NODIA

58. (A) (I), (II), (III), (IV)
The history of financial crises shows a clear timeline of emerging risks. In the late 1980s, American banks struggled with LDC credits. This was followed by the Japanese real estate crisis in the early 1990s and the Southeast Asian currency crisis in 1997. Finally, the 2007 Northern Rock crisis highlighted the risks of modern funding concentrations in capital markets.

59. (C) This net exposure need not be considered as an exposure.
The Large Exposure Framework allows for the offsetting of certain positions to determine net exposure. If the permitted offsetting results in a net short position for the bank, this specific exposure is not considered a risk to be limited. Consequently, the framework specifies that such net short positions need not be included when calculating the bank's total exposure to a counterparty.

60. (B) The relationship between changes in financial variables over time.
Financial correlations are essential metrics in portfolio risk management, as they measure the statistical relationship between changes in two or more variables over time. In credit portfolios, these correlations indicate how likely different borrowers or sectors are to experience financial distress simultaneously. Accurate correlation measurement allows banks to understand the potential for joint defaults and the benefits of diversification.

61. (C) It may accept a breach to help ensure overall stability in the interbank market.
Regulators maintain oversight over interbank limits to prevent systemic contagion. In stressed market circumstances, if a bank breaches an interbank exposure limit, the regulator might handle the situation ex post. They may choose to accept the breach temporarily if doing so helps maintain the overall stability of the interbank market, rather than forcing immediate liquidations that could worsen financial crises.

62. (B) (I) and (III) only
The shift toward measuring credit risk at the portfolio level is driven by several modern financial developments. Increased liquidity in secondary loan markets allows banks to sell off portions of their portfolios, while the availability of credit derivatives and third-party guarantees provides new ways to hedge concentrations. These tools enable more proactive management of total exposure compared to traditional monitoring.

63. (C) The value of the protected portion
When a bank utilizes unfunded credit protection, such as a guarantee or a credit derivative, the regulatory framework allows for a reduction in the reported exposure to the original counterparty. The value of the exposure is reduced by the specific amount of the protected portion. This ensures the bank's concentration limits accurately reflect the risk remaining with the primary borrower.

64. (D) (I), (II), (III), and (IV)
Calculating option exposure involves understanding various risk scenarios. Long call options are valued at market rates, while short put exposure is the strike price minus market value. In certain cases, like short calls or long puts, a default by the underlying entity can actually result in a profit. Finally, the framework ensures that negative net exposures are treated as zero.

65. (B) P-4, Q-1, R-2, S-3
Credit concentration risk increases for several reasons. Banks may focus on a specific sector to achieve specialization and market leadership. Economies of scale lower transaction costs as exposure to a firm grows. Additionally, rapid economic activity can offer higher profits, while operating in small markets naturally restricts diversification. These factors combine to create significant concentrations within a bank's portfolio.

66. (D) Ownership – Holding 20% of voting rights automatically satisfies control.
A control relationship between entities is established through substantial influence or legal rights, such as holding a majority of voting rights or the power to appoint board members. Merely owning twenty percent of an entity's voting rights is generally insufficient to automatically prove control under large exposure guidelines. Without additional

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Oct/Nov 2007

6. Identify the incorrect statement regarding the designated variables in Altman's Z-Score Model.

(A) X1 measures net working capital to total assets, indicating short-term liquidity and the capacity to meet obligations.

(B) X5 measures total debt to market capitalization, representing sales generating ability.

(C) X4 measures market value of equity to book value of total liabilities, providing a market-based leverage indicator.

(D) X2 measures retained earnings to total assets, capturing cumulative profitability and age of the firm over time.

May/June 2022

7. How are credit risk analysis models defined in terms of their core function for financial institutions?

(A) Algorithmic frameworks restricted to evaluating shadow bond ratings for specific commercial lending operations.

(B) Models using algorithms to predict defaults and borrower probability of default.

(C) Theoretical structures exclusively used for determining supervisory review process compliance and capital adequacy.

(D) Heuristic mechanisms designed to completely replace human resources in high-level lending and credit decisions.

Oct/Nov 2015

8. How does a statistical credit assessment model primarily function?

(A) It relies exclusively on the subjective experience of credit experts without requiring any empirical databases.

(B) It verifies hypotheses using statistical procedures on an empirical database of solvent and insolvent borrowers.

(C) It values corporate options strictly based on structural assets, liabilities, and assumed future market volatility.

(D) It actively flags potential qualitative management problems in the portfolio to facilitate early corrective action.

May/June 2009

9. Identify the correct statements regarding Multivariate Discriminant Analysis (MDA):

I The objective of MDA is to model a categorical dependent variable as a linear combination of independent variables.

II Discriminant analysis derives an equation that will discriminate best between groups in the dependent variable.

III The weights assigned to independent variables are referred to as discriminant coefficients.

Which of the above statements is/are correct?

(A) (I) and (II) only

(B) (II) and (III) only

(C) (I) and (III) only

(D) (I), (II), and (III)

NODIA

Oct/Nov 2011

10. Consider the following potential uses of credit models:

I To approve credit in the consumer lending business, often alongside a judgmental override.

II To determine 'shadow bond ratings' which influence portfolio and lending limits.

III To evaluate the costs and benefits of holding a financial asset using a mark-to-market model.

IV To act as general indicators for approving large corporate loans, though not generally used independently.

Which of the above are valid uses of credit models?

(A) (I), (II), and (IV) only

(B) (I), (II), and (III) only

(C) (II), (III), and (IV) only

(D) (I), (II), (III), and (IV)

May/June 2024

11. Identify the correct pair representing the Zones of Discrimination in Altman's Z-Score Model.

(A) $Z > 2.99$ — Grey Zone

(B) $1.8 < Z < 2.99$ — Distress Zone

(C) $Z < 1.80$ — Distress Zone

(D) $Z > 2.99$ — Default Zone

Oct/Nov 2006

12. Identify the incorrect statement regarding the application of credit models.

(A) Models may suggest the risk premiums that should be charged based on the probability of loss.

(B) Models are used to flag potential problems in the portfolio to facilitate early corrective

May/June 2023

63. Omega Capital is evaluating the credit portfolio of a firm using the structural credit risk model based on Merton's formula. The current value of the firm's assets (VA) is ₹ 200 million. The debt of the firm (D) to be paid on maturity is ₹ 180 million. The effective interest rate (r) is 5%. The volatility in asset value (σ_A) is 15%. Time to maturity (T-t) is 1 year. The firm's analysts calculate the value of d_1 to be 1.400.
Using the specific formula $d_2 = d_1 + \sigma_A \cdot \sqrt{T-t}$, what is the numerical value of d2 for this firm?
(A) 1.550
(B) 1.400
(C) 1.250
(D) 1.150

Oct/Nov 2014

64. Global Finance Bank strategically decides to overhaul its heuristic-based credit rating methodology for commercial loans. Due to the vast accumulation of complex, non-linear financial data gathered directly from continuous operations, they elect to implement an Artificial Neural Network (ANN) based credit risk identification model.
What unique operational capability will Global Finance Bank definitively acquire by transitioning to the ANN-based model that was structurally unachievable with their previous traditional models?
(A) The absolute ability to formulate mathematically precise hypotheses that are fully transparent to regulators.
(B) The strategic ability to guarantee a zero percent probability of default across corporate portfolios.
(C) The functional ability to perform online learning continuously as data is accumulated over time.
(D) The operational ability to eliminate the requirement for any historical training data entirely.

May/June 2010

65. Which of the following is NOT one of the standard layers in a typical 3-layer back propagation neural network structure?
(A) Input nodes
(B) Logit nodes
(C) Hidden nodes
(D) Output nodes

Oct/Nov 2024

66. Referencing the case in Question 63 and based on the derived d_2 value, what is the precise mathematical formula to calculate the Probability of Default (PD) for Omega Capital's evaluated firm?
(A) PD = N(1.250)
(B) PD = N(1.400)
(C) PD = N(-1.400)
(D) PD = N(-1.250)

May/June 2017

67. Consider the following specific features regarding Neural Networks in risk assessment:
I They arrive at operational decisions utilizing alternative implementations of a trial-and-error method.
II They are strategically intended to serve as an empirical complement, rather than a full substitute, for expert analysis.
III They consist of a 3-layer structure encompassing input, output, and hidden nodes.
IV The hidden layers actively transform raw data into high-dimensional non-linear features.
V They can perform dynamic online learning as critical data is accumulated over time.
Which combination of statements is correct?
(A) (I), (II), (III), and (IV) only
(B) (II), (III), (IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2005

68. What is the fundamental advantage of an ANN-based credit risk identification model over traditional risk measurement models?
(A) It can dynamically perform online learning as data is accumulated over time, a task unachievable by traditional models.
(B) It requires significantly less computational processing power and historical operational data to calibrate.
(C) It strictly mathematically assumes perfect linear relationships between all utilized financial variables.
(D) It categorically guarantees absolute

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May/June 2007

19. What is the general objective of multivariate discriminant analysis (MDA) within a credit assessment procedure?
(A) To model the dependence of a binary outcome strictly on structural market variables using logistic techniques.
(B) To evaluate the structural debt and equity components of a firm based exclusively on option pricing methodologies.
(C) To arrive at a decision using alternative systemic implementations of a computerized trial-and-error method.
(D) To distinguish between solvent and insolvent borrowers using a function with several creditworthiness criteria.

Oct/Nov 2025

20. The following question consists of two statements — Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): Heuristic models often suffer from a lack of transparency.
Reason (R): Different officers could reach different rating conclusions based on the same set of data because influence and weights are based on subjective experience.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2023

21. Match the Discriminant Variable in Altman's Z-Score Model (List I) with what it indicates (List II).
List I: (Discriminant Variable)
P. X1
Q. X2
R. X3
S. X4
List II: (Indicator)
1. Movement in asset value
2. Cumulative profitability
3. Productivity
4. Liquidity
(A) P-1, Q-4, R-2, S-3
(B) P-3, Q-1, R-4, S-2
(C) P-4, Q-2, R-3, S-1
(D) P-2, Q-3, R-1, S-4

Oct/Nov 2014

22. Which of the following is NOT listed as a direct use of credit models?
(A) Pricing of credit risk by suggesting risk premiums based on expected probability of loss.
(B) Dictating the exact numerical capital charge parameter used by regulatory authorities globally.
(C) Constructing a common credit language to achieve minimum credit quality for investors.
(D) Aiding in deciding the best collection or workout strategy if a borrower faces liquidity issues.

May/June 2010

23. In the classification of Credit Scoring Models, which of the following is NOT a sub-category of Heuristic Models?
(A) Rating template
(B) Expert Judgement System
(C) Decision Tree
(D) Reduced Form Models

Oct/Nov 2024

24. What was the sample size and exact composition used by Edward Altman (1968) for his original Z-score model?
(A) 22 bankrupt firms and 22 solvent firms
(B) 52 bankrupt firms and 52 solvent firms
(C) 104 bankrupt firms and 104 solvent firms
(D) 33 bankrupt firms and 33 solvent firms

May/June 2017

25. Which statement accurately describes the formulation of hypotheses in statistical models for credit assessment?
(A) Hypotheses are formulated utilizing purely subjective insights without consulting any historical empirical data sets.
(B) They state whether higher or lower values are expected on average for solvent versus insolvent borrowers.
(C) Hypotheses dictate that uniformly lower values of solvency indicators are expected

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for all solvent borrowers.
(D) Hypotheses completely ignore empirical data weighting and focus solely on structural future market projections.

Oct/Nov 2005

26. Which of the following statements regarding the quantitative uses of credit models is correct?
(A) They are frequently and predominantly used as the sole decision metric for approving large corporate loans.
(B) They replace the traditional credit analysis process entirely by assigning absolute finalized ratings.
(C) They act as all-inclusive risk control measures that do not require any judgmental override system.
(D) They are used to derive 'shadow bond rating' for unrated securities and commercial loans.

May/June 2020

27. In Altman's Z-Score model, why does the ratio X3 (EBIT to Total Assets) inherently have the highest contribution to the overall discrimination power?
(A) It is a robust measure of a firm's profitability and earning power, strongly linking directly to credit risk.
(B) It implicitly captures the exact chronological age of the firm and the extent of the company's leverage.
(C) It measures the short-term liquidity position, which is universally the primary cause of immediate corporate default.
(D) It comprehensively measures management's capacity in dealing with complex competitive conditions and industry effects.

Oct/Nov 2022

28. Match the specific sub-models (List I) to their broader classification category (List II).
List I: (Sub-models)
P. Rating template
Q. Multiple Discriminant analysis
R. Option Pricing based Structural Models
S. Artificial Neural Network
List II: (Classification Category)
1. Statistical Models
2. Causal Models
3. Heuristic Models
4. Computer-based systems performing parallel online learning
(A) P-3, Q-1, R-2, S-4
(B) P-1, Q-3, R-4, S-2
(C) P-4, Q-2, R-1, S-3
(D) P-2, Q-4, R-3, S-1

May/June 2018

29. Consider the following statements regarding Discriminant Analysis:
I The objective of multiple linear regression is to model one quantitative variable as a linear combination of other variables.
II Discriminant analysis derives an equation using non-linear combinations of dependent variables to discriminate best between groups.
Which of the following is correct?
(A) Both (I) and (II) are true.
(B) Both (I) and (II) are false.
(C) (I) is true, but (II) is false.
(D) (I) is false, but (II) is true.

NODIA

Oct/Nov 2016

30. Consider the following statements regarding Heuristic Models:
I Heuristic models are often grouped under the heading of expert systems in banking practice.
II A primary strength of heuristic models is that they are highly transparent and independent of subjective judgements.
Which of the following is correct?
(A) Both (I) and (II) are true.
(B) Both (I) and (II) are false.
(C) (I) is false, but (II) is true.
(D) (I) is true, but (II) is false.

May/June 2014

31. Referencing the data in Question 42 and using Altman's discriminant function $Z = 1.2X1 + 1.4X2 + 3.3X3 + 0.6X4 + 0.999X5$, what is the final calculated Z-score for Zenith Manufacturing Ltd.?
(A) 2.8438
(B) 2.1500
(C) 3.1438
(D) 3.4500

Oct/Nov 2019

32. In the Merton model, why is equity conceptually analogous to buying a call option on the assets of the firm?

(A) Borrowers inherently face an unlimited downside risk and a fixed potential upside return regardless of asset performance.

(B) Borrowers face only a limited downside risk of equity loss, but a very large potential upside return if things turn out well.

(C) Lenders predictably earn an unlimited return if the asset value exceeds the previously promised payment.

(D) Lenders face only a limited downside risk while systematically holding the vast majority of the firm's equity.

May/June 2025

33. Consider the following components regarding Altman's final discriminant function:

I Net Working Capital to Total Assets

II Retained Earnings to Total Assets

III Earnings Before Interest and Taxes to Total Assets

IV Market Value of Equity to Book Value of Total Liabilities

V Sales to Total Assets

Which of the above precisely reflect the five ratios comprising the function?

(A) (I), (II), and (III) only

(B) (II), (III), (IV), and (V) only

(C) (I), (III), (IV), and (V) only

(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2010

34. The following question consists of two statements — Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.

Assertion (A): In the Merton model framework, equity is analogous to buying a call option on the assets of the firm.

Reason (R): Borrowers face only a limited downside risk of loss of their equity investment but maintain a very large potential upside return if things turn out well.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

May/June 2008

35. Prof. Bandyopadhyay's Default Prediction Model for Indian Corporates is utilized to assess a mid-sized Indian manufacturing firm, Beta Corp. Beta Corp has Total Assets of ₹ 500 crores. Their Cash Profit stands at ₹ 50 crores, Operating Profit (PBIT) is ₹ 75 crores, and Sales for the year generated ₹ 750 crores. Net working capital is ₹ 100 crores. The Solvency Ratio (SOLVR) calculated directly from the balance sheet is 0.40.

What are the calculated numerical values for the ratios NWK/TA and CASHPROF/TA for Beta Corp?

(A) 0.20 and 0.10

(B) 0.10 and 0.20

(C) 0.20 and 0.15

(D) 0.15 and 0.10

Oct/Nov 2013

36. Referencing the case in Question 45, suppose an unexpected market crash drops the value of Alpha Logistics' assets significantly to ₹ 12 million, while the loan amount owed remains ₹ 15 million. What is the rational economic decision for the borrower under the strict Merton model framework?

(A) The borrower will mathematically default and hand over the assets worth ₹ 12 million to the bank.

(B) The borrower will unconditionally repay ₹ 15 million by raising personal funds to maintain reputation.

(C) The borrower will demand an operational increase in loan amount to ₹ 18 million.

(D) The borrower will systematically retain the ₹ 12 million and legally pay nothing to the bank.

May/June 2015

37. Which of the following pairs of Altman's Z-Score variables and their respective mathematical weighting factors is incorrectly matched?

(A) X1 (Working capital / Total asset) — 1.2 weighting factor

(B) X2 (Retained earnings / Total asset) —

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(equity holder) assuming they initially invested ₹ 3 million in the business?
(A) ₹ 15 million
(B) ₹ 12 million
(C) ₹ 0 million
(D) ₹ 3 million

Oct/Nov 2011

52. Referencing the case in Question 42, what are the calculated numerical values for X3 and X4 for Zenith Manufacturing Ltd?
(A) 0.80 and 0.25
(B) 0.30 and 0.80
(C) 0.25 and 1.20
(D) 0.25 and 0.80

May/June 2024

53. Consider the following structural variables related to the Default Prediction Model for Indian Corporates:
I Short-term liquidity is measured mathematically by Networking capital to total assets.
II The ratio CASHPROF/TA incorporates both depreciation and amortization.
III The Solvency ratio measures long-term solvency utilizing total assets and revaluation reserves.
IV Operating profit to total assets utilizes Profit After Tax (PAT) instead of PBIT.
Which of the above combination of statements is correct?
(A) (I), (II), and (III)
(B) (II), (III), and (IV)
(C) (I), (III), and (IV)
(D) (I), (II), and (IV)

Oct/Nov 2006

54. Consider the following statements regarding the structural Merton Model:
I The fundamental idea is that a company with limited liability defaults if the value of its assets is less than the debt of the company.
II The model conclusively dictates that equity holders face an unlimited downside risk in the event of default.
Which of the following is correct?
(A) Both (I) and (II) are true.
(B) Both (I) and (II) are false.
(C) (I) is true, but (II) is false.
(D) (I) is false, but (II) is true.

May/June 2016

55. How is the market value of assets of banks estimated according to structural credit risk models?
(A) It is implied using financial asset prices and volatilities of market-traded securities as it isn't directly observable.
(B) It is universally observed and verified directly from the firm's audited balance sheet and official financial filings.
(C) It is calculated strictly using the qualitative heuristic judgement of expert panels and professional valuation firms.
(D) It is derived purely by summing the historical book value of equity and the historical cost of all firm liabilities.

Oct/Nov 2021

56. The following question consists of two statements — Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): In Altman's Z-Score model, the ratio X3 possesses the highest contribution to the overall discrimination power of the model.
Reason (R): X3 is a direct measure of a firm's cumulative profitability over time, implicitly capturing the operational age of the firm.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2012

57. The following question consists of two statements — Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): The payoff function to the banker is structurally similar to writing a put option on the value of the borrower's assets with the loan amount functioning as the exercise price.
Reason (R): If the asset value is less than the loan amount, the debt holder stands to lose both interest and principal, up to the full limit

NODIA

(D) 0.15 and 1.50

May/June 2005

45. Prime Bank extended a loan of ₹ 15 million to Alpha Logistics. According to the structural credit risk model derived from Merton's framework, Alpha Logistics currently possesses assets valued at ₹ 18 million. The loan has reached its maturity. The promoters of Alpha Logistics are evaluating their options based on the structural asset and liability values.
If Alpha Logistics decides to pay off the loan entirely, what is the exact surplus value the borrower's owners (equity holders) will enjoy?
(A) ₹ 18 million
(B) ₹ 15 million
(C) ₹ 3 million
(D) ₹ 0 million

Oct/Nov 2023

46. Consider the following statements regarding the development of Altman's Z-Score Model:
I It was formulated based on a matched sample of 33 bankrupt and 33 solvent firms.
II The framework originally tested 22 potentially helpful financial ratios over a 20-year period.
III The final model derived an equation combining five best predictive ratios.
IV A Z-score greater than 2.99 explicitly indicates the firm is in the safe zone.
Which of the above combination is correct?
(A) (I), (II), and (IV) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

May/June 2019

47. Consider the following outcomes in the Merton Model when a firm raises funds:
I If the project turns out badly (asset value $<$ debt), owners default and turn over assets to debt holders.
II The firm's owners lose only their initial stake in the firm upon an event of default.
III If the firm does well, stockholders pay off the debt and keep the resulting difference.
Which of the above combination of outcomes is correct?
(A) Only (I) and (II)
(B) (I), (II), and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2007

48. Referencing the case in Question 42 and based strictly on the calculated Z-score of 3.1438, in which zone of discrimination does Zenith Manufacturing Ltd. fundamentally fall?
(A) Distress Zone
(B) Grey Zone
(C) Safe Zone
(D) Default Zone

May/June 2022

49. Match the mathematical variables utilized in the Merton model (List I) to their defined meanings (List II).
List I: (Mathematical Variables)
P. VE
Q. VA
R. D
S. N(d1)
List II: (Defined Meanings)
1. Value of the firm
2. Normal Distribution Variable
3. Value of equity
4. Debt of the firm
(A) P-3, Q-1, R-4, S-2
(B) P-1, Q-4, R-2, S-3
(C) P-2, Q-3, R-1, S-4
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2015

50. Which of the following accurately describes the structure of the dependent variable in a logit model?
(A) It is a linear combination of strictly qualitative variables.
(B) It is the exact probability of default ranging continuously from zero to infinity.
(C) It is the natural log of the odd ratio of Default to Non-default.
(D) It is the mathematical average of the independent creditworthiness criteria weighted equally.

May/June 2009

51. Referencing the case in Question 45, in the specific scenario where the asset value drops to ₹ 12 million, what is the exact maximum financial loss experienced by the borrower

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1.4 weighting factor
(C) X3 (EBIT / Total Asset) — 3.3 weighting factor
(D) X4 (Market value of equity / Book value of liabilities) — 0.999

Oct/Nov 2012

38. What is the primary analytical reason the Logit Model is designated with its name?
(A) Because it relies strictly on structural linear discriminant equations for probability and risk classification.
(B) Because it harnesses the logical trial-and-error approach inherent in artificial neural networks and logic systems.
(C) Because it is conceptually based on the logical deductive reasoning of seasoned credit experts and analyst panels.
(D) Because the default prediction model is developed using the Logistic Regression Technique.

May/June 2011

39. Which of the following formulas related to the Merton model framework is incorrectly stated?
(A) Probability of Default (PD) = $N(-d_2)$
(B) Value of equity (VE) $= V_A N(d_1) - e^{\{-r(T-t)\}} DN(d_2)$
(C) $d_1 = \dfrac{\ln\left(\frac{V_A}{D}\right) + \left(r + 0.5 \cdot \sigma_A^2\right)(T-t)}{\sigma_A \cdot \sqrt{T-t}}$
(D) $d_2 = d_1 + \sigma_A \cdot \sqrt{T-t}$

Oct/Nov 2020

40. Which of the following variables is NOT part of the Default Prediction Model for Indian Corporates developed by Prof Bandyopadhyay?
(A) NWK/TA (Networking capital to total assets ratio)
(B) CASHPROF/TA (Cash profit to total asset ratio)
(C) SOLVR (Solvency ratio)
(D) MVE/BVL (Market value of equity to book value of total liabilities)

May/June 2006

41. Referencing the case in Question 45, from Prime Bank's operational perspective as the lender, what is the calculated value of the loan at maturity if the borrower's asset value is precisely ₹ 12 million?
(A) ₹ 15 million
(B) ₹ 12 million
(C) ₹ 3 million
(D) ₹ 0 million

Oct/Nov 2008

42. Zenith Manufacturing Ltd. is being assessed for a commercial loan. The bank's risk analysts have compiled the following financial data for Zenith Manufacturing for the financial year ending 2023:
- Working Capital: ₹ 30 Lakhs
- Retained Earnings: ₹ 20 Lakhs
- Profit Before Interest and Tax (PBIT): ₹ 25 Lakhs
- Market Value of Equity: ₹ 80 Lakhs
- Book Value of Total Liabilities: ₹ 100 Lakhs
- Sales: ₹ 120 Lakhs
- Total Assets: ₹ 100 Lakhs

The bank utilizes Altman's Z-Score model to classify corporate borrowers.
Based on the financial data of Zenith Manufacturing Ltd., what is the computed value of the X1 and X2 variables respectively?
(A) 0.20 and 0.30
(B) 0.25 and 0.15
(C) 0.30 and 0.20
(D) 0.30 and 0.25

May/June 2013

43. Identify the incorrect statement regarding the banker's payoff in the structural credit risk model.
(A) The payoff function to the banker is mathematically similar to writing a put option on the borrower's total assets.
(B) If asset value exceeds the loan, the debt holder effectively enjoys the entire surplus of value over the debt.
(C) The objective value of the loan from the lender's perspective is always the minimum of the loan and asset value.
(D) If asset value is less than the loan amount, the borrower defaults and the debt holder stands to lose total capital.

Oct/Nov 2018

44. Referencing the case in Question 35, what are the calculated values for the ratios OPPROF/TA and SALES/TA for Beta Corp?
(A) 0.15 and 1.00
(B) 0.10 and 1.50
(C) 0.20 and 1.20

NODIA

if remaining assets equate to zero.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2009

58. Match the components of the Default Prediction Model for Indian Corporates (List I) to their respective calculation definitions (List II).
List I: (Model Components)
P. NWK/TA
Q. CASHPROF/TA
R. SOLVR
S. OPPROF/TA
List II: (Definitions)
1. Profit after tax plus depreciation and amortization divided by total assets
2. Operating profit before interest and tax divided by total assets
3. Current assets minus current liabilities divided by total assets
4. Total assets minus revaluation reserves and misc. expenses not written off divided by total borrowings plus current liability and provisions

(A) P-3, Q-1, R-4, S-2
(B) P-1, Q-4, R-2, S-3
(C) P-4, Q-2, R-3, S-1
(D) P-2, Q-3, R-1, S-4

May/June 2021

59. Identify the correct pair representing the fundamental payoff concepts defined within the structural Merton Model.
(A) Firm's assets > Debts — Firm voluntarily defaults and stockholders lose all initial stakes in the business entity.
(B) Firm's assets < Debts — Stockholders pay off the debt fully and keep the difference to maintain their reputation.
(C) Payoff to the banker — similar to writing a put option on the assets with the loan amount as exercise price.
(D) Equity position in a firm — Analogous to buying a put option on the firm's tangible assets and physical inventory.

Oct/Nov 2017

60. Referencing the case in Question 35 and utilizing the Indian Corporate default model equation

$$Z_{NEW} = -3.337 + 0.736(NWC/TA) + 6.95(CASH\ PROFIT/TA) + 0.864(SOLVR) + 7.554(OPPROF/TA) + 1.544(SALES/TA),$$

what is the precise numerical contribution of the OPPROF/TA variable alone to the Z_{NEW} score?
(A) 0.1472
(B) 1.1331
(C) 0.6950
(D) 2.3160

May/June 2007

61. Consider the following operational data processing steps of a typical artificial neural network (ANN) system:
I Financial variables are utilized as input nodes for input training data.
II Hidden layers effectively transform raw data into high-dimensional non-linear features.
III The output layer structurally classifies the accumulated data.
What is the correct sequential chronological order of these steps?
(A) (I), (II), (III)
(B) (II), (I), (III)
(C) (III), (I), (II)
(D) (I), (III), (II)

Oct/Nov 2025

62. Which of the following accurately describes the technical function of internal layers within an Artificial Neural Network (ANN) used for credit risk identification?
(A) The hidden layers transform raw data into high-dimensional non-linear features.
(B) The output layer transforms the raw data into high-dimensional non-linear features.
(C) The input layer directly classifies the data into distinct operational populations.
(D) The hidden layers are strictly utilized for gathering standard input training data.

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action.
(C) Credit rating models act as all-inclusive risk control measures for extending credit.
(D) Models can assist in selecting assets from a pool to construct a portfolio acceptable to investors.

May/June 2016

13. Consider the following steps in the development and application of statistical models for credit assessment procedures:
I Optimizing accuracy in the classification of solvent and insolvent borrowers.
II Deriving an objective selection and weighting of creditworthiness factors.
III Formulating hypotheses concerning potential creditworthiness criteria.
IV Ensuring the empirical data set is large enough to enable statistically significant statements.
What is the correct chronological sequence of these steps?
(A) (III), (II), (I), (IV)
(B) (IV), (III), (I), (II)
(C) (III), (IV), (II), (I)
(D) (II), (III), (I), (IV)

Oct/Nov 2021

14. In heuristic models, the flexibility that allows different officers to reach different rating conclusions based on the same set of data is considered:
(A) Exclusively a strength that enhances overall operational transparency and audit trails in decisioning.
(B) Exclusively a weakness that structurally invalidates the model's reliability and internal consistency.
(C) A strength and weakness, as the method depends heavily on the specific capabilities of the analyst.
(D) Irrelevant, as subjective experience has no impact on overall automated assessments or model output.

May/June 2012

15. Why does the fifth ratio (X5) in Altman's Z-Score model carry greater operational significance when evaluated as part of a group?
(A) It holds the highest mathematical weight (3.3) in the standard linear discriminant equation used by Altman.
(B) It explicitly measures the cumulative historical profitability of older, established firms over a long time.
(C) It is the singular ratio that evaluates the immediate short-term liquidity position of the firm under distress.
(D) It captures varying industry effects and relates uniquely to other predictive variables within the model.

Oct/Nov 2009

16. Under which regulatory framework must a bank develop a systematic approach to measuring, monitoring, and controlling credit risk?
(A) Basel I
(B) Basel II
(C) Basel III
(D) Basel IV

May/June 2021

17. In Altman's Z-Score model, what is the specific discriminant co-efficient (weighting factor) for the ratio of Market Value of Equity to Book Value of Total Liabilities (X4)?
(A) 1.2
(B) 1.4
(C) 3.3
(D) 0.6

NODIA

Oct/Nov 2017

18. Match the Uses of Credit Models (List I) with their corresponding descriptions (List II).
List I: (Uses of Credit Models)
P. Financial early warning
Q. Collection strategies
R. Pricing of credit risk
S. Credit rating determination
List II: (Descriptions)
1. Used to flag potential problems in the portfolio to facilitate corrective action.
2. Deriving 'shadow bond rating' for unrated securities and commercial loans.
3. Suggesting the risk premiums that should be charged based on loss probability.
4. Deciding on the best workout path if a borrower experiences short-term liquidity issues.
(A) P-1, Q-4, R-3, S-2
(B) P-2, Q-3, R-1, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

institutional immunity from default risk in all consumer lending operations.

May/June 2020

69. Identify the incorrect statement regarding the application of neural networks in credit risk modelling.

(A) Neural networks utilize alternative implementations of a trial-and-error method to arrive at decisions.

(B) Neural networks are expressly meant to substitute and replace an expert's analysis of a company's financial risk.

(C) An ANN-based model is typically first trained on the algorithm according to historical operational data.

(D) ANN models possess the ability to perform online learning continuously as data is accumulated over time.

Oct/Nov 2022

70. Referencing the case in Question 64, during the active operation of the newly implemented ANN system, how are the input financial variables processed immediately before the output layer classifies the data?

(A) They are instantly classified by the input nodes without any intermediate mathematical processing.

(B) They are transformed systematically into high-dimensional non-linear features by the hidden layers.

(C) They are mapped directly to corresponding structural option pricing parameters automatically.

(D) They are processed strictly utilizing linear discriminant functions isolated within the input layer.

NODIA

16. (B) Basel II
The Basel II regulatory framework introduced a more comprehensive approach to managing banking risks compared to its predecessor. It requires financial institutions to develop systematic methodologies for measuring, monitoring, and controlling credit risk. By implementing these standards, banks aim to align their capital requirements more closely with the actual risks they face, fostering greater stability and transparency in the global financial system.

17. (D) 0.6
The Altman Z-Score model utilizes five distinct financial ratios, each assigned a specific weighting factor based on its predictive power. For the fourth variable, which compares the market value of equity to the book value of total liabilities, the designated discriminant coefficient is 0.6. This weight reflects the variable's contribution to the overall model in identifying potential corporate financial distress.

18. (A) P-1, Q-4, R-3, S-2
Credit models are applied across various stages of the lending lifecycle to enhance risk management. Financial early warning systems identify portfolio problems for corrective action, while shadow bond ratings determine credit for unrated securities. Models also suggest risk premiums for pricing and assist in developing collection strategies. Each application uses data-driven insights to optimize financial decisions and minimize potential losses.

19. (D) To distinguish between solvent and insolvent borrowers using a function with several creditworthiness criteria.
Multivariate discriminant analysis is a core statistical procedure used in credit assessment to distinguish between solvent and insolvent borrowers. The method relies on a mathematical function that combines several creditworthiness criteria simultaneously. By analyzing these variables together, the model can more accurately categorize entities into distinct groups based on their financial health and the likelihood of experiencing future default events.

20. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Heuristic models often face challenges regarding transparency because they rely on the subjective judgment and experience of individual credit officers. Since the weights and influence of various factors are not strictly standardized through mathematical formulas, different analysts may reach different conclusions when evaluating the same data. This lack of uniformity directly results from the emphasis on intuition and trial-and-error logic.

21. (C) P-4, Q-2, R-3, S-1
The variables in Altman's Z-Score model serve as specific indicators for different financial aspects of a corporate entity. Variable X1 measures short-term liquidity, while X2 assesses cumulative profitability based on retained earnings. Variable X3 evaluates the firm's productivity and earning power. Finally, variable X4 acts as a leverage indicator by measuring movements in asset value relative to total liabilities.

22. (B) Dictating the exact numerical capital charge parameter used by regulatory authorities globally.
Credit models provide essential insights for pricing risk through premiums and establishing a common language for credit quality. They also guide collection strategies when borrowers face liquidity problems. However, these internal models do not dictate the exact numerical capital charge parameters used by global regulatory authorities. Regulators set these parameters independently through international frameworks like the Basel Accords to maintain systemic stability.

23. (D) Reduced Form Models
Heuristic models in credit scoring are characterized by their reliance on expert judgment and qualitative frameworks. Common sub-categories include rating templates, expert judgment systems, and decision trees. In contrast, reduced-form models are categorized as statistical or causal models that focus on market-based variables and default timing,

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8. (B) It verifies hypotheses using statistical procedures on an empirical database of solvent and insolvent borrowers.
Statistical credit assessment models operate by analyzing empirical databases containing information on both solvent and insolvent borrowers. These models utilize statistical procedures to verify hypotheses and determine the weighting of various financial factors. By objectively evaluating historical data, the models can identify patterns that distinguish between creditworthy entities and those likely to face default, ensuring a more data-driven lending approach.

9. (D) (I), (II), and (III)
Multivariate Discriminant Analysis is a statistical technique used to model a categorical dependent variable using a linear combination of several independent variables. The primary objective is to derive an equation that provides the best possible discrimination between different groups. Within this framework, the specific weights assigned to each independent variable are known as discriminant coefficients, which quantify their relative predictive importance.

10. (D) (I), (II), (III), and (IV)
Credit models serve various quantitative and qualitative functions within a banking institution's operations. They are used for approving consumer loans, determining shadow bond ratings for unrated entities, and establishing lending limits. Additionally, these models help evaluate the costs of holding financial assets through mark-to-market valuations and act as general indicators for assessing large corporate loans alongside human judgment.

11. (C) $Z < 1.80$ — Distress Zone
Altman's original research established specific numerical thresholds known as zones of discrimination to categorize the financial health of corporate entities. A Z-score below the value of 1.80 signifies that a firm is in the distress zone, indicating a high probability of impending bankruptcy. This classification serves as a critical indicator for lenders when assessing the risk of default during the underwriting process.

12. (C) Credit rating models act as all-inclusive risk control measures for extending credit.
Credit models are valuable tools for identifying risk premiums and flagging potential portfolio problems to allow for early intervention. They also assist in selecting assets for investor-acceptable portfolios. However, these models should not be viewed as all-inclusive risk control measures. They require judgmental overrides and human oversight to ensure that complex qualitative factors are considered alongside the quantitative model outputs.

13. (C) (III), (IV), (II), (I)
The development of statistical models for credit assessment follows a logical chronological progression. First, analysts formulate hypotheses regarding potential creditworthiness criteria. They then secure an empirical data set large enough to ensure statistical significance. This foundation allows for the objective selection and weighting of factors. Finally, the procedure focuses on optimizing classification accuracy for solvent and insolvent borrowers.

14. (C) A strength and weakness, as the method depends heavily on the specific capabilities of the analyst.
In heuristic models, the degree of flexibility that allows different credit officers to reach varying conclusions using the same data is viewed as both a strength and a weakness. This variability occurs because the methodology depends heavily on the subjective experience and specific capabilities of the analyst. While it allows for nuanced judgment, it also introduces inconsistency and potential subjectivity.

15. (D) It captures varying industry effects and relates uniquely to other predictive variables within the model.
The fifth ratio in the Altman model, which measures sales relative to total assets, carries significant operational importance when analyzed within the group of variables. This ratio is particularly useful for capturing industry-specific effects and the firm's capacity to generate sales. Because it relates uniquely to other predictive variables, its contribution helps refine the model's overall ability to discriminate between firms.

NODIA

ANSWERS

1. (D) To select assets from a pool to construct an investor-acceptable portfolio or obtain a credit rating.
Underwriters employ credit models to create a standardized framework for assessing risk across diverse asset classes. This systematic approach allows for the selection of specific assets from a broader pool to develop investment portfolios that meet the requirements of institutional investors. Establishing this uniform methodology facilitates the acquisition of credit ratings and ensures consistency in evaluation processes for lenders.

2. (A) (I), (II), and (III)
The reliability of statistical credit risk models relies heavily on the quality of empirical data and the use of objective mathematical procedures. Statistical methods derive creditworthiness factors from historical evidence, provided the datasets are well-tested and robust. Conversely, heuristic models depend on qualitative past experiences rather than pure statistical rigor, while structural models incorporate liability assumptions for firm evaluation.

3. (D) (I), (II), and (III)
Several factors have contributed to the increasing importance of quantitative credit risk modeling within modern financial systems. Banks are adopting more rigorous numerical approaches, while the expansion of credit derivative markets has improved loan marketability. Additionally, regulatory authorities are focused on enhancing bank capital requirement systems to ensure greater financial stability and more accurate risk assessment across the global banking industry.

4. (B) Grey Zone
Altman's discriminant function utilizes specific score ranges to determine the probability of corporate bankruptcy. A Z-score falling between 1.81 and 2.99 identifies a firm as belonging to the grey zone. This intermediate classification suggests that the firm's financial health is uncertain, requiring closer monitoring and additional qualitative analysis to determine the actual risk of future default or survival events.

5. (B) A framework attempting to gain insights methodically on the basis of previous experiences and trial-and-error.
Heuristic models represent a methodical framework used for credit risk evaluation that relies significantly on historical experience and trial-and-error techniques. These systems aim to gain insights by capturing the subjective knowledge of expert credit officers. Rather than using purely mathematical variables, heuristic models focus on qualitative assessments and past patterns to reach a decision regarding the creditworthiness of various borrowers.

6. (B) X5 measures total debt to market capitalization, representing sales generating ability.
Within the Altman Z-Score framework, each variable represents a specific financial dimension of the firm being evaluated. While X1 through X4 measure liquidity, profitability, productivity, and leverage, the variable designated as X5 represents the sales generating ability of the company. It is calculated as the ratio of sales to total assets, rather than comparing debt to market capitalization.

7. (B) Models using algorithms to predict defaults and borrower probability of default.
Credit risk analysis models serve as algorithmic frameworks designed to enhance the decision-making process within financial institutions. These models utilize specific quantitative and qualitative data to predict the likelihood of default and estimate the probability of default for individual borrowers. By using these mathematical structures, banks can more accurately evaluate risk and manage their lending portfolios in a systematic manner.

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rather than relying on the subjective insights and trial-and-error logic of human experts.

24. (D) 33 bankrupt firms and 33 solvent firms
Edward Altman developed the original Z-score model in 1968 using a matched sample of manufacturing firms. The study included thirty-three firms that had filed for bankruptcy and a corresponding group of thirty-three solvent firms. This specific composition allowed for a rigorous comparison of financial ratios, enabling the identification of variables that most effectively discriminated between companies at risk and healthy ones.

25. (B) They state whether higher or lower values are expected on average for solvent versus insolvent borrowers.
In the context of statistical credit models, the formulation of hypotheses involves making specific predictions about how financial indicators behave. These hypotheses establish whether higher or lower values are expected on average when comparing solvent borrowers to those who are insolvent. This process provides the theoretical basis for testing empirical data and determines which variables will be included in the final model.

26. (D) They are used to derive 'shadow bond rating' for unrated securities and commercial loans.
One of the significant quantitative applications of credit models is the derivation of shadow bond ratings. This process is particularly useful for assessing unrated securities and commercial loans that lack a formal rating from a credit agency. By providing a proxy for credit quality, these models help financial institutions establish portfolio limits and make more informed decisions regarding their investments.

27. (A) It is a robust measure of a firm's profitability and earning power, strongly linking directly to credit risk.
The third ratio in Altman's model, which measures earnings before interest and taxes against total assets, is a powerful indicator of a firm's earning capability. It consistently shows the strongest contribution to the model's ability to discriminate between healthy and distressed firms. This reflects the fact that a company's fundamental profitability is the most critical factor in its long-term financial survival.

28. (A) P-3, Q-1, R-2, S-4
Credit risk models are classified into different categories based on their underlying methodology. Heuristic models include rating templates, while statistical models encompass techniques like multiple discriminant analysis. Causal models include structural approaches based on option pricing. Additionally, artificial neural networks represent advanced computer-based systems that perform parallel online learning, allowing them to adapt as new financial data becomes available.

NODIA

29. (C) (I) is true, but (II) is false.
Linear regression and discriminant analysis are distinct statistical techniques used for different types of modeling tasks. Multiple linear regression is designed to model a single quantitative variable as a linear combination of others. While discriminant analysis also uses linear combinations, it specifically aims to distinguish between groups in a categorical variable, rather than relying on non-linear combinations as the primary method.

30. (D) (I) is true, but (II) is false.
Heuristic models are frequently classified as expert systems because they formalize the knowledge and intuition of experienced credit professionals. However, a significant characteristic of these models is that they are not inherently transparent. Because they rely heavily on subjective judgments and personal experience, they may lack the objective independence found in purely statistical or mathematical models used for credit assessment.

31. (C) 3.1438
Calculating the Altman Z-score involves applying specific weights to five financial ratios. For this entity, the ratios are determined as X1 equals 0.30, X2 equals 0.20, X3 equals 0.25, X4 equals 0.80, and X5 equals 1.20. Multiplying these by their coefficients and summing the products results in a finalized numerical score of 3.1438 for the manufacturer.

32. (B) Borrowers face only a limited downside risk of equity loss, but a very large potential upside return if things turn out well.
The Merton model views firm equity through the lens of option pricing theory. Equity holders are seen as possessing a call option because they have limited downside risk, as they can only lose their initial investment. If the firm's assets increase in value beyond the debt obligations, the equity holders retain the entire upside, similar to the payoff structure of a call.

33. (D) (I), (II), (III), (IV), and (V)
The Altman Z-Score model for manufacturing firms is built upon five specific financial ratios that cover various aspects of financial health. These include measures of liquidity, cumulative profitability, current earning power, and market-based leverage. Additionally, the model incorporates a ratio measuring sales efficiency. Together, these five metrics provide a comprehensive quantitative picture that allows for the effective discrimination of corporate bankruptcy risk.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
In the Merton framework, stockholders are viewed as holding a call option on the firm's assets. This analogy is accurate because the owners' potential losses are restricted to their initial equity investment, providing a limited downside. Conversely, they stand to gain significantly if the asset value grows well beyond the debt, effectively capturing all the surplus value in successful business scenarios.

35. (A) 0.20 and 0.10
The financial ratios for Beta Corp are determined by dividing specific data points by total assets. With total assets of five hundred crores, the networking capital of one hundred crores results in an NWK/TA ratio of 0.20. Similarly, the cash profit of fifty crores results in a CASHPROF/TA ratio of 0.10. These metrics provide essential quantitative inputs for default prediction models.

36. (A) The borrower will mathematically default and hand over the assets worth ₹ 12 million to the bank.
Under the strict framework of the Merton structural model, a borrower's decision at the time of debt maturity depends on the value of the firm's assets relative to its liabilities. If the assets are worth less than the loan amount, the rational economic choice for the borrower is to default. In this scenario, the borrower simply relinquishes the assets to the lender.

37. (D) X_4 (Market value of equity / Book value of liabilities) — 0.999
Each variable in the Altman Z-Score model is multiplied by a specific mathematical coefficient that reflects its importance in predicting default. While X1 is weighted at 1.2, X_2 at 1.4, and X_3 at 3.3, the coefficient for X_4 is actually 0.6. The factor of 0.999 is reserved for the fifth variable, X_5, which represents the firm's sales to total assets ratio.

38. (D) Because the default prediction model is developed using the Logistic Regression Technique.
The Logit model is a widely used statistical approach for predicting the probability of binary outcomes, such as default or non-default. Its name is derived from the fact that the underlying mathematical framework is built upon the logistic regression technique. This method allows analysts to model the relationship between various independent financial variables and the likelihood of a specific credit event occurring.

39. (D) $d_2 = d_1 + \sigma_A \cdot \sqrt{T-t}$
The Merton model employs several complex formulas to calculate the probability of default and the value of equity. These calculations involve specific variables such as firm value, debt at maturity, and asset volatility. In the standard derivation of these metrics, the variable d2 is mathematically defined as d1 minus the product of asset volatility and the square root of time.

40. (D) MVE/BVL (Market value of equity to book value of total liabilities)
The default prediction model specifically developed for Indian corporates by Prof.

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Bandyopadhyay incorporates five key financial variables. These include measures of networking capital, cash profit, and operating profit, all relative to total assets. Additionally, the model utilizes a solvency ratio and sales efficiency. It does not, however, include the market value of equity to total liabilities ratio found in Altman's model.

41. (B) ₹ 12 million
From a lender's perspective in a structural model, the payoff at the time of loan maturity is the lower of the promised debt payment or the actual value of the firm's assets. If the firm's assets have depreciated to a level below the original loan amount, the bank only receives the value of those remaining assets following the borrower's default.

42. (C) 0.30 and 0.20
To calculate the X_1 and X_2 variables for the Altman model, one must use specific balance sheet items. X_1 is the ratio of working capital to total assets, while X_2 represents retained earnings relative to total assets. For the firm described, these calculations yield values of 0.30 and 0.20, respectively, providing the initial quantitative inputs for the overall Z-score determination.

43. (B) If asset value exceeds the loan, the debt holder effectively enjoys the entire surplus of value over the debt.
In structural credit risk modeling, the payoff function for a lender is conceptually linked to the value of the firm's underlying assets. If the asset value is lower than the outstanding loan amount, the borrower defaults, and the debt holder assumes control of the remaining capital. However, the debt holder does not share in any surplus value exceeding the loan amount.

44. (D) 0.15 and 1.50
Beta Corp's performance is analyzed using specific profitability and efficiency ratios. With total assets of five hundred crores, an operating profit of seventy-five crores yields an OPPROF/TA ratio of 0.15. Additionally, the sales of seven hundred fifty crores result in a SALES/TA ratio of 1.50. These values are used within the Indian corporate default model to assess financial health.

45. (C) ₹ 3 million
When a firm's assets exceed its total liabilities at the time of loan maturity, the equity holders can pay off the debt and retain the remaining value. In this case, subtracting the fifteen million loan from the eighteen million in assets leaves a three million surplus. This amount represents the net value enjoyed by the owners after fulfilling their financial obligations.

46. (D) (I), (II), (III), and (IV)
The development of the Altman Z-Score involved several rigorous steps, including testing twenty-two financial ratios over two decades. The final model combined the five most predictive ratios using a sample of bankrupt and solvent firms. This research established clear zones of discrimination, with any score exceeding 2.99 indicating that a company is in a financially safe position with low default risk.

47. (B) (I), (II), and (III)
The Merton model outlines clear outcomes for firm owners based on the performance of their projects. If a project fails and asset value drops below debt, owners default and lose only their stake. However, if the project is successful, stockholders pay off the debt and keep the difference. This structure highlights the limited liability and potential upside associated with corporate equity.

48. (C) Safe Zone
After applying the financial data to the Altman discriminant function, the resulting Z-score determines the firm's risk category. For Zenith Manufacturing, the calculated score of 3.1438 is compared against established thresholds. Since this value is higher than the cutoff of 2.99, the firm is fundamentally classified as being in the safe zone, suggesting a strong financial position and low default risk.

49. (A) P-3, Q-1, R-4, S-2
The Merton model utilizes specific mathematical variables to value firm equity and assess default risk. Within this framework, VE represents the value of equity, while VA denotes the total value of the firm. D refers to the firm's debt at maturity, and the term N(d1) is a normal distribution variable used in the option pricing formula to determine equity value.

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50. (C) It is the natural log of the odd ratio of Default to Non-default.
In a logit model used for credit risk analysis, the dependent variable has a unique mathematical structure. It is defined as the natural logarithm of the odds ratio, which compares the probability of default to the probability of non-default. This transformation allows the model to map probabilities to a continuous linear scale, facilitating the analysis of how different variables influence risk.

51. (D) ₹ 3 million
Because of the principle of limited liability, the maximum financial loss for an equity holder is restricted to their initial investment in the business. Even if the firm's asset value drops significantly and the company defaults on its loans, the owners are not personally liable for the remaining debt. Therefore, the loss is capped at the amount they originally contributed.

52. (D) 0.25 and 0.80
The X3 and X4 variables in the Altman model provide critical insights into earning power and leverage. X3 is calculated as profit before interest and tax divided by total assets, while X4 measures the market value of equity against total liabilities. For the firm in the scenario, these calculations result in numerical values of 0.25 and 0.80 for each respective ratio.

53. (A) (I), (II), and (III)
The default prediction model for Indian corporates uses several specific financial metrics. Short-term liquidity is measured by the ratio of networking capital to total assets, while cash profit includes both depreciation and amortization. The solvency ratio assesses long-term health using total assets and revaluation reserves. However, operating profit is measured using profit before interest and taxes rather than net income.

54. (C) (I) is true, but (II) is false.
Structural credit risk models, such as the Merton model, are based on the assumption that default occurs when firm assets fall below debt levels. This framework highlights the limited liability of equity holders, who do not face unlimited downside risk. Instead, their potential losses are capped at their initial investment, while lenders bear the risk of asset value dropping further.

55. (A) It is implied using financial asset prices and volatilities of market-traded securities as it isn't directly observable.
For many financial institutions and firms, the true market value of assets is not directly observable on a balance sheet. Structural credit risk models address this by implying the market value through other observable data. This estimation process utilizes current financial asset prices and the volatilities of market-traded securities to derive a realistic valuation of the firm's underlying asset base.

56. (C) Assertion (A) is true, but Reason (R) is false.
In the Altman Z-Score model, the ratio X_3, representing earnings before interest and taxes relative to total assets, demonstrates the highest contribution to discrimination power. This variable serves as a direct measure of a firm's earning power and operational profitability. However, it does not measure the chronological age of the company, which is instead captured by the X_2 variable.

57. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The structural framework of credit risk defines the payoff to a lender in terms of option theory. By extending a loan, the banker essentially writes a put option on the firm's assets, where the loan amount serves as the exercise price. If asset values fall below the debt, the lender faces the risk of losing both interest and principal payments.

58. (A) P-3, Q-1, R-4, S-2
The default prediction model for Indian corporates uses four primary components with specific calculation definitions. Networking capital to total assets measures liquidity, while cash profit to total assets includes non-cash charges. The solvency ratio compares adjusted total assets to total liabilities. Finally, operating profit to total assets measures earning power. These components provide a comprehensive view of a firm's creditworthiness.

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59. (C) Payoff to the banker — similar to writing a put option on the assets with the loan amount as exercise price.
The Merton model provides a clear structural view of the payoffs for both equity and debt holders. The lender's position is comparable to having written a put option on the firm's assets, with the loan value as the strike price. This means the lender faces losses only when assets fall below the debt amount, while the borrower holds the upside.

60. (B) 1.1331
The contribution of a specific variable to the Z_{NEW} score is found by multiplying its calculated ratio by its assigned coefficient. For the firm in question, the operating profit to total assets ratio is 0.15. When this is multiplied by the model's coefficient of 7.554, it results in a precise numerical contribution of 1.1331 toward the final risk score.

61. (A) (I), (II), (III)
The processing of data within an artificial neural network follows a strict sequential order to achieve accurate classification. Initially, financial variables are introduced through input nodes as training data. This information is then passed to hidden layers, which transform the data into complex features. Finally, the output layer processes these features to categorize the borrower into the appropriate risk population.

62. (A) The hidden layers transform raw data into high-dimensional non-linear features.
Artificial neural networks are designed with internal layers that perform critical data transformations for credit risk identification. These hidden layers are responsible for converting raw input variables into high-dimensional, non-linear features. This step is essential because it allows the model to capture complex relationships within the financial data that traditional linear models are unable to process or identify effectively.

63. (C) 1.250
In the Merton framework, the variable d_2 is a key component for calculating default probability. It is derived by taking the calculated value of d1 and subtracting the product of asset volatility and the square root of time to maturity. For a firm with a d1 of 1.400 and 15% volatility over one year, the resulting d_2 value is 1.250.

64. (C) The functional ability to perform online learning continuously as data is accumulated over time.
Transitioning to an artificial neural network allows a bank to leverage capabilities that traditional models cannot provide. A primary operational advantage is the system's ability to perform online learning continuously. As the bank accumulates more operational data over time, the ANN can update its internal parameters, allowing it to adapt to changing market conditions and refine its risk assessments dynamically.

65. (B) Logit nodes
Standard back-propagation neural networks are typically organized into three primary layers to process information. These include input nodes for receiving data, hidden nodes for performing complex transformations, and output nodes for final classification. While logit models are a separate type of statistical technique, they do not constitute a standard structural layer within the architecture of a typical artificial neural network.

66. (D) PD = N(-1.250)
The probability of default in the Merton model is calculated using the standard normal cumulative distribution function. Once the value for d_2 has been determined, the probability is found by taking the normal distribution of the negative d_2 value. This mathematical step quantifies the likelihood that the firm's assets will be worth less than its debt at the time of maturity.

67. (D) (I), (II), (III), (IV), and (V)
Neural networks offer several unique features for credit risk assessment within the banking sector. They utilize trial-and-error methods to reach decisions and are designed to complement expert analysis. Structurally, they use hidden layers to transform data into non-linear features and can perform continuous online learning. These characteristics allow them to handle the complex, high-dimensional datasets typically generated during operations.

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68. (A) It can dynamically perform online learning as data is accumulated over time, a task unachievable by traditional models.
Artificial neural networks provide a distinct advantage over traditional risk models due to their dynamic nature. Unlike static statistical models, an ANN can engage in online learning, meaning it continuously improves its predictive accuracy as it processes new data. This allows financial institutions to maintain more responsive and adaptive credit risk identification systems that evolve alongside the firm's actual operational experience.

69. (B) Neural networks are expressly meant to substitute and replace an expert's analysis of a company's financial risk.
Neural networks are sophisticated tools designed to assist in credit risk modeling rather than replacing the fundamental judgment of human experts. These systems function as an empirical complement to traditional analysis by processing complex datasets. While they can perform continuous online learning, the strategic goal remains to enhance the decision-making process instead of entirely substituting expert financial evaluations.

70. (B) They are transformed systematically into high-dimensional non-linear features by the hidden layers.
Within an artificial neural network structure, the data processing sequence is crucial for accurate risk classification. Before reaching the output layer, input financial variables are directed through internal hidden layers. These hidden layers perform complex mathematical operations to transform raw data into high-dimensional non-linear features. This transformation allows the system to identify patterns that are not apparent in linear models.

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CHAPTER 11

Measurement of Credit Risk

Oct/Nov 2018

1. Under the Marginal Cost based Lending Rate (MCLR) framework, which of the following is the correct formula to calculate the Negative carry on CRR?

(A) $\frac{\text{Required CRR} \times \text{marginal cost}}{1 + \text{CRR}}$

(B) $\frac{\text{Required CRR} \times \text{operating cost}}{1 - \text{CRR}}$

(C) $\frac{\text{Required CRR} \times \text{tenorpremium}}{1 - \text{CRR}}$

(D) $\frac{\text{Required CRR} \times \text{marginal cost}}{1 - \text{CRR}}$

May/June 2005

2. Which of the following statements concerning the Probability of Default (PD) is incorrect?

(A) The probability of default is a statistical measure quantifying the likelihood that a borrower will default usually over a one-year period.

(B) The probability of default is never strictly zero, even for very strong entities.

(C) Default probabilities decrease with time as uncertainties increase, making PD estimation over long periods highly reliable.

(D) Default does not necessarily lead to immediate losses but increases the possibility of future default and resultant loss.

Oct/Nov 2021

3. How is Exposure at Default (EAD) defined under credit risk measurement?

(A) The portion of the loan facility currently extended to the borrower, strictly excluding any potential future drawdowns or undrawn commitments.

(B) The anticipated average loss the bank expects to suffer over a one-year horizon based on historical default rates and risk segments.

(C) The outstanding amount at default, including drawn funds and expected future drawdowns of currently unused credit lines.

(D) The potential for actual credit losses to exceed the expected loss due to volatility in the default rates or recovery values.

May/June 2023

4. What is the most appropriate interpretation of Stress Loss in the context of the probability density function of credit losses?

(A) It is the maximum loss over a target horizon with a low, pre-specified probability within a given confidence interval.

(B) It is the average deviation of expected losses measured at the 50% confidence interval under normal market conditions.

(C) It is the potential unexpected loss beyond the targeted confidence level that is judged too expensive to be covered by capital.

(D) It is the normal cost of doing business covered by standard provisioning and pricing policies derived from historical loss data.

Oct/Nov 2007

5. The rationale of the core risk level relates directly to a bank's continuity as a going concern. How does management utilize the concept of core risk level during periods of abnormal market volatility?

(A) Management increases the exposure to core assets to offset the volatility of non-core exposures and maintain the desired weighted average return.

(B) Management seeks to reduce risk to the minimum desired level to stabilize profitability by phasing out non-core exposures.

(C) Management ignores core risk level and focuses solely on expected losses to determine provisions based on current accounting standards.

(D) Management fully eliminates the risk in

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(B) ₹ 2.00 million
(C) ₹ 2.50 million
(D) ₹ 8.00 million

May/June 2025

42. Match the risk management terms in List I with their mathematical or conceptual expressions in List II.
List I: (Terms)
P. Expression for EL
Q. Expression for UL
R. Credit VaR or EC
S. RAROC numerator
List II: (Expressions)
1. $k \times ULp - ELp$
2. $EAD \times LGD \times \sqrt{PD \times (1 - PD)}$
3. Interest income + Fee income – Cost of fund – Cost of operation – Expected loss
4. $EAD \times PD \times LGD$
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-4, Q-2, R-1, S-3
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2014

43. Review the following statements concerning Risk Adjusted Return on Capital (RAROC):
I. RAROC evaluates risk-adjusted performance by equating the capital cushion to be provided for potential loss.
II. A fundamental principle of RAROC is to charge a rational price for the risk it assumes.
III. By definition, RAROC dictates that capital should be redeployed to under-performing activities to boost their expected returns.
IV. The higher the volatility of the returns, the more capital is allocated under RAROC.
Which of the above statement(s) is/are correct?
(A) I, II, and III
(B) I, II, and IV
(C) II, III, and IV
(D) I, III, and IV

May/June 2019

44. Consider the following statements regarding the computation of Loss Given Default (LGD):
I. Workout LGD uses a set of estimated cash flows resulting from the workout and/or collections process, properly discounted.
II. Implied Market LGD is derived from the prices of defaulted bonds only, ignoring theoretical asset pricing models.
III. Market LGD is observed from market prices of defaulted bonds or marketable loans soon after the actual default event.
Which of the above statement(s) is/are correct?
(A) I and II only
(B) II and III only
(C) I and III only
(D) I, II, and III

Oct/Nov 2006

45. Based on the scenario for Goodluck Ltd, the company also holds a Cash Credit facility with a limit of ₹ 10 mln and an outstanding amount of ₹ 6 mln. The applicable Credit Conversion Factor (CCF) is 20%. Calculate the Exposure at Default (EAD) for the Cash Credit facility.
(A) ₹ 6.00 mln
(B) ₹ 10.00 mln
(C) ₹ 6.80 mln
(D) ₹ 8.00 mln

May/June 2021

46. Match the methods of measuring LGD in List I with their descriptions in List II.
List I: (Methods)
P. Market LGD
Q. Workout LGD
R. Implied Market LGD
S. LGD percentage
List II: (Descriptions)
1. Derived from risky (but not defaulted) bond prices using a theoretical asset pricing model.
2. Estimated cash flows resulting from the collections process, properly discounted.
3. 1 minus Recovery Rate percentage.
4. Observed from market prices of defaulted bonds or marketable loans soon after the actual default event.
(A) P-2, Q-3, R-1, S-4
(B) P-4, Q-2, R-1, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-1, Q-4, R-2, S-3

Oct/Nov 2010

47. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct answer using the options provided.

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(A) I, II, III
(B) II, I, III
(C) III, II, I
(D) II, III, I

May/June 2018

12. In credit risk measurement, risk exposure is often identified through four primary drivers. Which of the following correctly lists these four drivers?
(A) Probability of default, Expected loss, Unexpected loss, and Value at Risk
(B) Default probability, Credit rating matrix, Exposure at default, and Recovery rate
(C) Probability of default, Loss given default, Exposure at default, and Effective maturity
(D) Loss given default, Exposure at default, Economic capital, and Effective maturity

Oct/Nov 2015

13. Which of the following statements regarding the computation of Marginal Cost of Funds based Lending Rate (MCLR) is incorrect?
(A) All operating costs, including those recovered via service charges, must be included in the Operating Costs component of the MCLR.
(B) The marginal cost of funds comprises the marginal cost of borrowings and return on net worth as determined by the bank's board.
(C) The change in tenor premium should not be borrower specific or loan class specific but should reflect the market term structure.
(D) Negative carry on the mandatory CRR arises due to the return on CRR balances being nil relative to the marginal cost of funds.

May/June 2007

14. Which of the following statements correctly describes a characteristic of the typical credit rating transition matrix?
(A) As one goes down the rating scale, the probability of a multi-notch movement in rating rapidly decreases.
(B) Given the initial rating, the second largest probability of possible ratings are usually located furthest away from the diagonal.
(C) There is a higher chance of credit migration in the same direction than for opposite direction in consecutive years.
(D) Lower ratings have greater stability and a higher retention rate than higher grades.

Oct/Nov 2025

15. When choosing between different external benchmarks for floating rate personal or retail loans, which of the following is an appropriate requirement for a bank to ensure transparency?
(A) The bank must adopt multiple external benchmarks within a single loan category to offer variety.
(B) The bank must use the MCLR framework for all personal loans without adopting external benchmarks.
(C) The bank must link the spread exclusively to the Government of India 3-Months Treasury Bill yield.
(D) The bank must adopt a uniform external benchmark within a loan category.

May/June 2012

16. What is the precise definition of Loss Given Default (LGD) in the context of credit risk measurement?
(A) The magnitude of likely loss on the exposure, expressed as a percentage of the exposure at default
(B) The likelihood that a borrower will default during some future period
(C) The outstanding amount including drawn amounts plus likely future drawdowns of unused lines
(D) The maximum potential loss within a one-year period at a 99 percent confidence level

Oct/Nov 2014

17. An institution uses several methods to compute the pricing structure for its various products under risk-based pricing. Which of the following is NOT a recognized practice for risk-based pricing?
(A) Internal rate of return based pricing
(B) Return on risk assets basis (RORA)
(C) Economic profit-based pricing
(D) RAROC based pricing

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earn risk-adjusted returns in excess of a prescribed target.

Oct/Nov 2019

31. Which of the following pairs concerning the components of a bank's pricing model is correctly matched?

(A) Cost of raising funds — Covers Personnel Expense, Administrative and Other Operating Expense.

(B) Profit margin — Compensation strictly meant for the default risk arising from the borrower.

(C) Credit risk premium — Loaded into the pricing to cover undertaking credit risk, liquidity risk, portfolio risk, and country risk.

(D) Operating expenses — The weighted average cost of raising funds from SB accounts, Current accounts, and Term Deposits.

May/June 2013

32. Consider the following components used in pricing and Marginal Cost based Lending Rate (MCLR) calculation:

I. Marginal cost of borrowings
II. Return on net worth
III. Negative carry on SLR
IV. Operating Costs
V. Tenor Premium

Which of the above correctly form the exclusive components of the MCLR structure?

(A) I, II, III, and IV
(B) I, II, IV, and V
(C) II, III, IV, and V
(D) I, III, IV, and V

Oct/Nov 2011

33. Match the factors influencing LGD in List I with their correct characteristics in List II.

List I: (Factors)

P. Facility characteristics
Q. Firm-specific capital structure
R. Industry factors
S. Macroeconomic factors

List II: (Characteristics)

1. Assets that can be readily reused by another party have higher liquidation values.
2. Size of the loan has a positive impact; fund-based loans have relatively lower LGD.
3. Low leverage borrowers have low LGD; a higher ratio of assets to liabilities is better.
4. GDP growth rate, unemployment rate, and interest rate capture economic cycle effects.

(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2024

34. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct answer using the options provided.

Assertion (A): In a standard credit transition matrix, the probability observation density diminishes rapidly as we move away from the diagonal to the right side of the table.

Reason (R): Obligors are most likely to maintain their current rating, generating a high probability factor on the diagonal.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2008

35. Read the following statements about Core Risk Level and select the correct option:

I. The core risk level is the maximum risk exposure a bank can assume before regulatory capital is exhausted.
II. When market conditions show more than normal volatility, management seeks to reduce risk exposure to the core business level to protect profitability.

(A) Only I
(B) Only II
(C) Both I and II
(D) Neither I nor II

May/June 2006

36. Assuming Goodluck Ltd has a third facility, a Performance Bank Guarantee with a limit of

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(C) Tenor premium
(D) Unexpected loss capital charge

Oct/Nov 2023

25. Regarding the factors that contribute to recovery and Loss Given Default (LGD), which of the following statements is incorrect?
(A) Fund-based loans generally have relatively lower LGD than non-fund-based loans.
(B) Low leverage borrowers have high LGD; similarly, the higher the current ratio, the higher the LGD.
(C) The quality of collateral lowers the LGD, and more liquid collaterals have low LGD.
(D) More competitive industries are associated with stronger recoveries and help increase recovery rates.

May/June 2010

26. Which of the following provides the correct definition of Economic Capital?
(A) The capital required by regulators to be reflected in the balance sheet on the day of its compilation
(B) A measure of the profitability of an investment or business after accounting for risk
(C) The amount of credit loss the bank would expect to experience on its credit portfolio over the chosen time horizon
(D) The capital required to protect the bank against unexpected future losses at a selected confidence level

Oct/Nov 2024

27. Which of the following represents the best operational proxy for maximizing the return on shareholders' investments in the context of risk management?
(A) Maximizing the risk-adjusted return on capital (RAROC) for each transaction
(B) Minimizing the Expected Loss of all asset portfolios
(C) Maximizing the Capital Adequacy Ratio (CAR) to exceed Economic Capital
(D) Maximizing the Value at Risk (VaR) at a 99.9% confidence level

May/June 2017

28. How does the cohort approach differ conceptually from the duration approach when estimating migration probabilities from credit transition matrices?
(A) The cohort approach observes start-to-end proportions ignoring intra-year movements, while the duration approach tracks all rating changes and state durations.
(B) The cohort approach records mid-year transitions and time spent in each state, while the duration approach only observes the start and end of the year.
(C) The cohort approach removes firms whose ratings migrated to Not Rated status to maintain a consistent sample size throughout the observation period.
(D) The cohort approach divides the time spent in the starting rating by the migration intensity, assuming transitions follow a continuous Markov process.

Oct/Nov 2005

29. Regarding internal lending rate benchmarks, which of the following types of loans are generally exempted from the provisions of Marginal Cost based Lending Rate (MCLR), except:
(A) Advances to banks' depositors against their own deposits
(B) Advances granted to the Chief Executive Officer / Whole Time Directors
(C) Fixed rate loans of tenor up to one year
(D) Working Capital Term Loan (WCTL) granted as part of a restructuring package

May/June 2020

30. Which of the following correctly identifies a principle of risk-adjusted return on capital (RAROC)?
(A) RAROC is optimized when a bank eliminates all expected losses from its credit portfolio.
(B) The higher the capital allocation in RAROC, the smaller the cash flows the transaction must generate to offset volatility.
(C) RAROC dictates that the risk-adjusted return must be consistently lower than the minimum return for similar risks required by shareholders.
(D) A bank should redeploy capital away from under-performing activities to those that

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Oct/Nov 2007

53. Read the following statements regarding External Benchmarks for lending and select the correct option:

I. Banks are allowed to adopt multiple external benchmarks within the same loan category to offer competitive choices to borrowers.

II. Credit risk premium may undergo change only when a borrower's credit assessment undergoes a substantial change, as agreed upon in the loan contract.

(A) Only I
(B) Only II
(C) Both I and II
(D) Neither I nor II

May/June 2025

54. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct answer using the options provided.

Assertion (A): The cohort approach provides a highly detailed accounting of all intra-year rating fluctuations by tracking daily rating changes.

Reason (R): The cohort approach just takes the observed proportions from the beginning of the year to the end, meaning any movements within the year are not accounted for.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2019

55. Consider the following statements about MCLR and Spread components:

I. The spread charged to an existing borrower cannot be increased except on account of deterioration in the credit risk profile.

II. Business strategy component takes into consideration market competition and embedded options in the loan product.

III. Other components of spread under external benchmark including operating cost can be altered once every year.

IV. Negative carry on CRR uses the formula: $\text{Required CRR} \times (\text{marginal cost}) / (1 - \text{CRR})$.

Which of the above statement(s) is/are correct?

(A) I, II, and III
(B) I, II, and IV
(C) II, III, and IV
(D) I, III, and IV

May/June 2009

56. Match the components of MCLR and Pricing in List I with their definitions in List II.

List I: (Components)

P. Negative Carry on CRR
Q. Operating Costs
R. Tenor Premium
S. Credit risk premium

List II: (Definitions)

1. Overhead expenses covering personnel, administrative, and other non-operating expenses.
2. Arises due to the return on mandatory reserve balances being nil.
3. Compensation to the bank for the default risk arising from loan sanctioned based on rating models.
4. Arises from loan commitments with longer duration and should not be borrower specific.

(A) P-2, Q-1, R-4, S-3
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2011

57. The following questions are based on the credit profile of Goodluck Ltd. Goodluck Ltd enjoys certain credit facilities from ABC Ltd. As of 31.03.2021, the Term Loan facility has a limit of ₹ 50 mln and an outstanding amount of ₹ 65 mln. Applying the standard conversion, what is the Exposure at Default (EAD) for the Term Loan facility of Goodluck Ltd?

(A) ₹ 65.00 mln
(B) ₹ 50.00 mln
(C) ₹ 55.00 mln
(D) ₹ 70.00 mln

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₹ 3 mln, an outstanding amount of ₹ 3 mln, and a CCF of 50%. Based on all three facilities (Term Loan EAD = ₹ 65.00 mln, Cash Credit EAD = ₹ 6.80 mln), what is the total Exposure at Default (EAD) of Goodluck Ltd?
(A) ₹ 73.30 mln
(B) ₹ 74.00 mln
(C) ₹ 71.50 mln
(D) ₹ 72.80 mln

Oct/Nov 2017

37. Match the elements of credit risk exposure in List I with their corresponding definitions in List II.
List I: (Elements)
P. PD
Q. LGD
R. EAD
S. M
List II: (Definitions)
1. The amount of money at risk.
2. The likelihood that the counterparty will default.
3. The time period in which some or all of the money is outstanding.
4. The amount of money a bank is likely to lose in case of default.

(A) P-2, Q-4, R-1, S-3
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2008

38. Evaluate the following statements about the Credit Rating Transition Matrix:
I. It shows the complete possible states that a rating can take over a given time horizon.
II. The observation density diminishes rapidly as we move to the right side of the table away from the diagonal.
III. The cohort approach divides the time spent in the starting rating to obtain the migration intensity.
IV. High volatility in certain low-grade categories is partly because some of the high-risk firms are 'do-or-die' type firms.
Which of the above statement(s) is/are correct?
(A) I, II, and III
(B) II, III, and IV
(C) I, II, and IV
(D) I, III, and IV

Oct/Nov 2016

39. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct answer using the options provided.
Assertion (A): Expected loss represents a normal cost of doing business and should be priced into the yield of the loan.
Reason (R): Expected loss is the anticipated average loss the bank can expect to suffer over a 1-year horizon and is generally expected to be absorbed by operating income.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2015

40. Which of the following pairs regarding the exemptions from internal lending rate provisions is incorrectly matched?
(A) Fixed rate loans — Exempted if the tenor is over three years.
(B) Advances to bank employees — Exempted, including retired employees.
(C) Advances to depositors — Exempted if granted against their own deposits.
(D) WCTL is exempted only if granted outside of a formal rectification or debt restructuring package.

NODIA

Oct/Nov 2012

41. Read the following scenario regarding a corporate loan: A financial institution manager sanctions a loan of ₹ 200 million to a BB-rated corporate client. The bank's internal transition matrix establishes the Probability of Default (PD) for BB-rated companies at 4% over a 1-year horizon. Due to the nature of the collateral, the expected Loss Given Default (LGD) is mapped at 25%. Using the transaction level formula, what is the Expected Loss (EL) of the loan?
(A) ₹ 1.50 million

May/June 2019

18. Which of the following expressions represents the Unexpected Loss (UL) at the transaction level?

(A) $UL = EAD \times LGD \times \sqrt{PD \times (1 - PD)}$
(B) $UL = EAD \times PD \times LGD \times \sqrt{1 - PD}$
(C) $UL = EAD \times \sqrt{LGD \times PD \times (1 - PD)}$
(D) $UL = EAD \times LGD \times (PD - 1)$

Oct/Nov 2010

19. Which of the following statements regarding Economic Capital and Regulatory Capital is incorrect?

(A) Economic capital is a measure of risk, not of capital held, and is expressed as a rupee level of capital necessary to adequately support specific risks assumed.
(B) When estimating economic capital, banks employ an analytical framework relating it to the portfolio's probability density function (PDF) of credit losses.
(C) For an enterprising organization, the regulatory capital (CAR) will generally be less than the estimated economic capital.
(D) The Capital Adequacy Ratio (CAR) reflected in the balance sheet is held on the day of its compilation, taking into account the future cost of risk shocks exactly as economic capital does.

May/June 2016

20. Which of the following statements accurately reflects the components of Spread under the Marginal Cost based Lending Rate (MCLR) system?

(A) Business strategy as a component of spread takes into consideration embedded options in the loan product and market liquidity of the loan.
(B) The spread charged to an existing borrower can be increased at any time without any change in the credit risk profile of the customer.
(C) Credit risk premium charged to the customer is independent of customer relationship, expected losses, and collaterals.
(D) Operating costs are frequently altered every month as part of the spread.

Oct/Nov 2009

21. What is the correct chronological sequence of steps involved in the process of PD calculation using historical rating migration matrices?

I. Estimate PD for each bucket using external or internal historical loss data.
II. Determine the weighted average PDs for obligors in each bucket.
III. Rate the obligor using expert judgement or a quantitative model.
IV. Bucket the obligors into one of the seven or more grades.

(A) III, IV, I, II
(B) IV, III, I, II
(C) III, I, IV, II
(D) I, III, IV, II

May/June 2011

22. Which specific formula is used to calculate the Expected Loss (EL) at the transaction level?

(A) $EL = EAD \times LGD \times \sqrt{PD \times (1 - PD)}$
(B) $EL = EAD \times PD \times LGD$
(C) $EL = k \times ULp - ELp$
(D) $EL = EAD \times (1 - \text{Recovery Rate})$

Oct/Nov 2020

23. In the context of economic capital and the probability density function (PDF) of credit losses, what does the Value-at-Risk (VaR) at a given confidence level represent?

(A) The maximum expected loss covered by normal provisioning over a one-year horizon based on the bank's historical performance.
(B) The potential unexpected loss against which it is judged to be too expensive to hold capital, represented by the tail of the loss distribution.
(C) The average deviation of expected losses corresponding to a 99.9% probability of survival for the institution under stressed conditions.
(D) The sum of EL and UL representing the maximum loss over a horizon such that there is a low probability of exceeding it.

May/June 2022

24. The internal benchmark MCLR comprises several components. Which of the following is NOT a component of MCLR?

(A) Marginal cost of funds
(B) Negative carry on account of CRR

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Assertion (A): The estimation of Exposure at Default (EAD) is necessary for the computation of regulatory as well as economic capital.
Reason (R): Credit exposure varies from product to product, and borrower usage trends of committed credit lines provide clues to understand cyclical risks.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2005

48. Which of the following pairs regarding the characteristics of a typical average one-year transition matrix is incorrectly matched?
(A) Highest probability factor — Concentrated along the diagonal indicating obligors maintain their current rating.
(B) Rating scale movement — As one goes down the rating scale, the probability of multi-notch movement rapidly decreases.
(C) Secondary probability concentration — Direct neighbourhood of the diagonal.
(D) Rating stability — Higher ratings generally exhibit greater stability or higher retention rates than lower grades.

Oct/Nov 2022

49. Identify the loan types in the following list:
I. Advances to banks' own employees including retired employees.
II. Advances to banks' depositors against their own deposits.
III. Floating rate personal or retail loans sanctioned after October 01, 2019.
IV. Fixed rate loans of tenor over three years.
V. Advances granted to the Chief Executive Officer / Whole Time Directors.
Which of the given statements represent correct exemptions from the provisions of Marginal Cost based Lending Rate (MCLR)?
(A) I, II, III, and IV
(B) I, II, IV, and V
(C) II, III, IV, and V
(D) I, III, IV, and V

May/June 2018

50. Consider the following statements regarding the factors affecting LGD:
I. A lower ratio of assets to liabilities implies low leverage and therefore leads to a lower LGD.
II. More liquid collaterals reduce LGD, while senior collaterals experience a lower LGD than subordinated ones.
III. Industry factors such as high competitiveness and ready reuse of assets by other parties result in lower liquidation values and higher LGD.
Which of the above statement(s) is/are correct?
(A) I and II only
(B) II only
(C) I and III only
(D) II and III only

Oct/Nov 2016

51. If ABC Ltd successfully executes a Recovery Rate (RR) of 55% on Goodluck Ltd's total EAD in the event of default, what will be the percentage of Loss Given Default (LGD) calculated by the bank?
(A) 55%
(B) 100%
(C) 20%
(D) 45%

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May/June 2014

52. Which of the following pairs concerning the approaches to reading transition matrices is correctly matched?
(A) Cohort Approach — Counts all rating changes over the course of the year and divides by the time spent in the starting rating.
(B) Duration Approach — Counts the observed proportions from the beginning of the year to the end, ignoring mid-year movements.
(C) Duration Approach — Assumes all rating migrations happen abruptly at the end of the year.
(D) Cohort Approach — Removes firms whose ratings were withdrawn or migrated to Not Rated (NR) status from the sample.

core exposure by utilizing credit economic capital allocations to hedge against specific market shocks.

May/June 2014

6. Why is the estimation of Expected Loss (EL) critical in portfolio assessment of credit risk?
(A) EL dictates the exact amount of regulatory capital a bank must maintain for solvency under the Basel III framework requirements.
(B) EL is the average loss that must be priced into the yield and covered by operating income through provisioning.
(C) EL estimates enable the bank to calculate the exact future date a borrower will default based on current macroeconomic conditions.
(D) EL indicates the maximum potential loss within a one-year period at a 99% confidence level as defined by internal risk models.

Oct/Nov 2022

7. Which of the following best defines the Probability of Default (PD)?
(A) The amount of money a bank is likely to lose in case of default
(B) The likelihood that the counterparty will default
(C) The time period in which some or all of the money is outstanding
(D) The amount of money at risk at the time of default

May/June 2009

8. Which of the following statements correctly describes the measurement of Exposure at Default (EAD)?
(A) EAD represents only the outstanding drawn amount because future drawdowns cannot be accurately predicted based on historical borrower behavior.
(B) Unused credit lines are converted to notional outstanding using a Credit Conversion Factor prescribed by risk frameworks.
(C) Exposure risk in a term loan is considered extremely high because of its fixed repayment schedule and the lack of flexibility in credit limits.
(D) Credit line usage rates decline monotonically as the borrower becomes riskier and approaches default, reducing the bank's overall exposure risk.

Oct/Nov 2013

9. The measurement of Loss Given Default (LGD) broadly utilizes three methods. Which of the following is NOT one of these broad ways of measuring LGD for an instrument?
(A) Market LGD
(B) Cohort LGD
(C) Workout LGD
(D) Implied Market LGD

May/June 2021

10. Expected Loss (EL) and Unexpected Loss (UL) are two dimensions of measuring credit risk. Which of the following best explains the conceptual difference between them?
(A) EL represents the maximum possible loss in extreme conditions, while UL represents the normal cost of doing business across the credit portfolio.
(B) EL is covered entirely by economic capital, while UL is absorbed by operating income and standard provisioning according to regulatory norms.
(C) EL is the average loss priced into yield, while UL is the loss volatility necessitating capital protection.
(D) EL measures the variance of the loss distribution, while UL measures the statistical mean of the loss distribution over a specified period.

Oct/Nov 2006

11. According to the MCLR framework, the tenor premium must correspond to specific maturity buckets. What is the correct logical sequence of conditions applied to determine the maturity bucket for calculating the tenor of the MCLR?
I. If no single bucket exceeds 30 percent, calculate the cumulative weightage based on the descending order of the maturity time buckets.
II. Identify if the tenor of the funds in the single largest maturity bucket is more than 30 percent of the entire funds (other than equity).
III. Arrive at the weighted average tenor of two or more maturity buckets that together account for more than 30 percent.

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May/June 2010

58. Read the following statements regarding Expected Loss (EL) and Unexpected Loss (UL) and select the correct option:

I. Expected losses represent a cost of doing business and are generally expected to be absorbed by operating income.

II. Unexpected loss is the potential for actual loss to exceed the expected loss, necessitating the holding of capital protection.

(A) Only I
(B) Only II
(C) Both I and II
(D) Neither I nor II

Oct/Nov 2024

59. Consider the following notions regarding the Probability of Default (PD) and risk measurement:

I. PD is a statistical measure which quantifies the likelihood that a borrower will default usually over a one-year period.

II. The probability of default of a borrower can be absolute zero if the entity generates extremely strong revenues.

III. Default probabilities tend to increase with time as uncertainties increase.

IV. Credit migration matrices characterize past changes in credit quality of obligors.

V. The transition matrix provides a summary of how all rated borrower accounts have migrated from one grade to another.

Which of the combinations correctly represents true statements?

(A) I, II, III, and V
(B) I, III, IV, and V
(C) II, III, IV, and V
(D) I, II, IV, and V

May/June 2017

60. Consider the following statements comparing Economic Capital and Regulatory Capital:

I. Economic capital is a forward-looking measure of capital adequacy, whereas Capital Adequacy Ratio (CAR) is held on the day of balance sheet compilation.

II. Economic capital strictly follows traditional accounting measures without factoring in the probability density function of credit losses.

III. Economic capital estimates the capital buffer between CAR and the future cost of risk shocks.

Which of the above statement(s) is/are correct?

(A) I and II only
(B) I and III only
(C) II and III only
(D) I, II, and III

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Oct/Nov 2005

61. If the bank assessing Portfolio Alpha has an internal hurdle rate of 15% for economic profit calculations, what is the Economic Profit generated by Portfolio Alpha?

(A) ₹ 12,00,00,000
(B) ₹ 43,00,00,000
(C) ₹ 31,00,00,000
(D) ₹ 21,00,00,000

May/June 2020

62. If the collateral value of the ₹ 200 million loan drops significantly, causing the revised LGD to rise to 40%, what will be the direct mathematical effect on the Unexpected Loss (UL), assuming PD and EAD remain constant?

(A) UL will increase proportionally with the increase in LGD.
(B) UL will remain unchanged since EL absorbs the collateral shock.
(C) UL will decrease because higher LGD reduces exposure variance.
(D) UL will decrease by the square root of the LGD percentage.

Oct/Nov 2015

63. Based on the loan transaction of ₹ 200 million with a PD of 4% and LGD of 25%, which of the following equations correctly reflects the calculation of the standard deviation of default for this specific transaction?

(A) $\sqrt{0.25 \times 0.75}$
(B) $\sqrt{0.04 \times 0.25}$
(C) $\sqrt{0.04 \times 0.96}$
(D) $\sqrt{200 \times 0.04}$

May/June 2013

64. Using the previously calculated Marginal Cost of funds of 6.40%, and a Required CRR of 4.0%, calculate the Negative carry on CRR using the formula $\frac{\text{RequiredCRR} \times (\text{marginal cost})}{(1 - \text{CRR})}$.

(A) 0.250%

(B) 0.240%
(C) 0.266%
(D) 0.275%

Oct/Nov 2021

65. For Portfolio Alpha, with a Net income before losses of ₹ 45,00,00,000 and the Expected Loss calculated at ₹ 2,00,00,000, what is the net Income after expected losses?
(A) ₹ 41,00,00,000
(B) ₹ 43,00,00,000
(C) ₹ 45,00,00,000
(D) ₹ 35,00,00,000

May/June 2024

66. For the ₹ 200 million loan sanctioned to the BB-rated client with a PD of 4% and LGD of 25%, what is the Unexpected Loss (UL) of the loan? (Note: $\sqrt{0.0384} \approx 0.19596$)
(A) ₹ 19.596 million
(B) ₹ 4.899 million
(C) ₹ 2.450 million
(D) ₹ 9.798 million

Oct/Nov 2008

67. The following data relates to the computation of the Marginal Cost based Lending Rate (MCLR) for a bank for a 1-year tenor:
Marginal cost of Borrowing = 6.00% (Weight = 90%);
Return on Net Worth = 10.00% (Weight = 10%).
Calculate the Marginal Cost of funds.
(A) 6.00%
(B) 5.40%
(C) 7.00%
(D) 6.40%

May/June 2006

68. Ignoring taxes, calculate the RAROC for Portfolio Alpha based on the Income after expected losses of ₹ 43,00,00,000 and the allocated Economic Capital of ₹ 80,00,00,000.
(A) 53.75%
(B) 43.00%
(C) 21.50%
(D) 56.25%

Oct/Nov 2017

69. Evaluate the performance of Portfolio Alpha based on the provided financial parameters: Portfolio balance = ₹ 2,00,00,00,000; Net income before losses = ₹ 45,00,00,000; Probability of Default (PD) = 4%; Loss Given Default (LGD) = 25%; Economic capital = ₹ 80,00,00,000. Based on these parameters, what is the Expected Loss (EL) amount for Portfolio Alpha?
(A) ₹ 20,00,00,000
(B) ₹ 2,00,00,000
(C) ₹ 8,00,00,000
(D) ₹ 4,00,00,000

May/June 2008

70. Based on the calculated Marginal Cost of funds (6.40%) and Negative carry on CRR (0.266%), along with given parameters Operating Cost = 1.50% and Tenor Premium = 0.30%, determine the final MCLR for the 1-year tenor.
(A) 8.166%
(B) 8.466%
(C) 8.200%
(D) 8.500%

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ANSWERS

1. (D) $\frac{\text{RequiredCRR} \times \text{marginal cost}}{1 - \text{CRR}}$

The Marginal Cost based Lending Rate framework uses specific mathematical formulas for its various components. Negative carry on the Cash Reserve Ratio is a cost banks incur because these mandatory reserves earn no interest. It is mathematically determined by multiplying the required ratio by the marginal cost of funds, then dividing by the difference of one and the reserve ratio.

2. (C) Default probabilities decrease with time as uncertainties increase, making PD estimation over long periods highly reliable.
Probability of default is a statistical measure of the likelihood of a borrower failing to meet obligations. While it is useful for short horizons, estimating this probability over long periods is generally less reliable. This is because default probabilities typically increase over time as macroeconomic uncertainties and institutional risks grow, making long-term predictions significantly more difficult and less stable.

3. (C) The outstanding amount at default, including drawn funds and expected future drawdowns of currently unused credit lines.
Exposure at Default represents the total estimated amount to which a bank is exposed at the moment a borrower defaults. This measurement includes not only the current outstanding funds already drawn by the borrower but also the anticipated future drawdowns from existing unused credit lines. It provides a comprehensive view of the potential financial risk during default scenarios.

4. (C) It is the potential unexpected loss beyond the targeted confidence level that is judged too expensive to be covered by capital.
In credit risk management, stress loss refers to potential losses that occur in extreme market conditions. It represents the potential unexpected loss residing in the tail of the probability density function. These losses fall beyond the targeted confidence level and are deemed too expensive for banks to cover with standard capital allocations, necessitating specific stress testing and monitoring.

5. (B) Management seeks to reduce risk to the minimum desired level to stabilize profitability by phasing out non-core exposures.
The core risk level is fundamentally linked to the survival of a bank as a going concern. During times of extreme market volatility or economic stress, management prioritizes stability. They achieve this by reducing overall risk to the minimum desired level. This involves phasing out non-core or highly volatile exposures to stabilize profitability and protect the institution's financial health.

6. (B) EL is the average loss that must be priced into the yield and covered by operating income through provisioning.
Expected loss is a fundamental metric for assessing the average credit risk within a portfolio. It is considered a normal cost of doing business rather than a risk volatility measure. Banks must price this expected loss into the interest rate or yield of the loan. This ensures that operating income can cover necessary provisions according to accounting and regulatory standards.

7. (B) The likelihood that the counterparty will default
The probability of default is a key parameter in credit risk modeling. It quantifies the statistical likelihood that a counterparty or borrower will fail to meet their contractual debt obligations within a specified time frame. This measure is essential for calculating expected losses and determines the underlying risk profile of the credit exposure for the lending institution during assessment.

8. (B) Unused credit lines are converted to notional outstanding using a Credit Conversion Factor prescribed by risk frameworks.
Measuring exposure at default involves analyzing both drawn and undrawn components

NODIA

25. (B) Low leverage borrowers have high LGD; similarly, the higher the current ratio, the higher the LGD.
Recovery rates and loss given default are influenced by the financial structure of the borrower. Generally, a lower ratio of assets to liabilities signifies higher leverage and increased risk. Therefore, borrowers with high leverage typically exhibit higher loss given default. Conversely, a higher current ratio or lower leverage indicates a stronger financial position, which usually leads to a lower loss.

26. (D) The capital required to protect the bank against unexpected future losses at a selected confidence level
Economic capital is a sophisticated risk management concept used by financial institutions. It represents the amount of capital required to protect the bank against unexpected future losses at a chosen confidence level. Unlike regulatory capital, which follows standard rules, economic capital is internally determined based on the bank's specific risk profile and the probability distribution of potential losses in its portfolio.

27. (A) Maximizing the risk-adjusted return on capital (RAROC) for each transaction
For a bank seeking to maximize value for its shareholders, identifying an effective operational proxy is vital. Maximizing the risk-adjusted return on capital for every transaction serves as this proxy. By ensuring that every deal generates returns exceeding the cost of the capital allocated to its specific risk, the institution effectively optimizes overall profitability while maintaining prudent risk management standards.

28. (A) The cohort approach observes start-to-end proportions ignoring intra-year movements, while the duration approach tracks all rating changes and state durations.
Estimating migration probabilities from credit transition matrices involves two primary methodologies. The cohort approach provides a simplified view by observing rating proportions from the start to the end of a period, ignoring any movements that occur mid-year. In contrast, the duration approach is more detailed, tracking every rating change and the specific amount of time spent in each state.

29. (C) Fixed rate loans of tenor up to one year
The Marginal Cost based Lending Rate framework applies to most bank advances, but certain categories are specifically exempted. Exemptions include loans against the bank's own deposits and advances to the Chief Executive Officer or directors. However, fixed rate loans with a tenor up to one year are generally required to follow the internal benchmark provisions and are not naturally exempted.

30. (D) A bank should redeploy capital away from under-performing activities to those that earn risk-adjusted returns in excess of a prescribed target.
A core principle of risk-adjusted return on capital is the efficient allocation of resources. This methodology dictates that a bank should actively manage its portfolio by redeploying capital. Specifically, capital should be moved away from under-performing business activities that do not meet hurdle rates and directed toward those that earn risk-adjusted returns exceeding the target required by the bank's shareholders.

31. (C) Credit risk premium — Loaded into the pricing to cover undertaking credit risk, liquidity risk, portfolio risk, and country risk.
Pricing models in banking include several distinct components to ensure all risks are covered. The credit risk premium is a critical loading added to the interest rate. It compensates the institution for undertaking various forms of risk, including credit default, liquidity, portfolio concentration, and country risk. This ensures the pricing is sufficient to cover the potential costs of these exposures.

32. (B) I, II, IV, and V
The internal structure of the Marginal Cost based Lending Rate consists of four mandatory components defined by regulation. These are the marginal cost of funds, which includes the return on net worth, the negative carry on the Cash Reserve Ratio, general operating costs, and the tenor premium. Notably, costs related

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happens. This value is expressed as a percentage of the total exposure at default, reflecting the portion of funds that the bank cannot recover.

17. (A) Internal rate of return based pricing
Risk-based pricing involves several sophisticated methodologies to ensure that the price of a loan reflects its underlying risk profile. Common practices include calculating the return on risk-adjusted capital, return on risk assets, and economic profit. While internal rate of return is a standard financial metric for measuring investment profitability, it is not specifically categorized as a risk-based pricing methodology.

18. (A) $UL = EAD \times LGD \times \sqrt{PD \times (1 - PD)}$
Calculating unexpected loss at the transaction level requires understanding the volatility of default. The mathematical expression involves multiplying the total exposure at default by the loss given default. This product is then multiplied by the square root of the probability of default and its complement. This calculation quantifies the potential deviation from the average expected loss for a specific credit instrument.

19. (D) The Capital Adequacy Ratio (CAR) reflected in the balance sheet is held on the day of its compilation, taking into account the future cost of risk shocks exactly as economic capital does.
Regulatory capital and economic capital serve different purposes in bank risk management. The Capital Adequacy Ratio reflected in financial statements represents a snapshot of capital held on a specific day. Unlike economic capital, which is a forward-looking measure factoring in the probability density function of future credit losses and shocks, regulatory capital provides a static view of current compliance levels.

20. (A) Business strategy as a component of spread takes into consideration embedded options in the loan product and market liquidity of the loan.
Under the Marginal Cost based Lending Rate system, the spread component reflects specific business and risk factors. The business strategy element of the spread incorporates various market-related considerations. These include the valuation of embedded options within the loan product and the overall market liquidity of the asset. Such components allow banks to adjust pricing based on strategic objectives and market conditions.

21. (A) III, IV, I, II
The process of calculating the probability of default using rating migration matrices follows a logical sequence. First, the obligor is rated using quantitative models or expert judgment. Next, obligors are grouped into specific grades or buckets. Then, the probability of default is estimated for each bucket using historical data. Finally, the weighted average probability for all obligors is determined.

22. (B) $EL = EAD \times PD \times LGD$
Expected loss is a statistical estimate of the average loss a bank anticipates on a credit transaction. The formula used to calculate this amount at the transaction level is the product of three variables. These are the exposure at default, the probability of default, and the loss given default. This calculation helps banks determine the appropriate provisioning and pricing for credit risk.

23. (D) The sum of EL and UL representing the maximum loss over a horizon such that there is a low probability of exceeding it.
In the context of the probability density function of credit losses, Value-at-Risk at a specific confidence level provides a comprehensive risk measure. It represents the sum of the expected loss and the unexpected loss. This value indicates the maximum potential loss over a given time horizon that the bank can expect not to exceed, based on a pre-defined probability level.

24. (D) Unexpected loss capital charge
The Marginal Cost based Lending Rate is an internal benchmark comprised of four distinct regulatory components. These include the marginal cost of funds, the negative carry on the Cash Reserve Ratio, the operating costs, and the tenor premium. While capital charges for unexpected losses are important for bank solvency, they are not part of the formula used to calculate MCLR.

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of a credit facility. For unused credit lines, banks apply a conversion factor to estimate how much of the limit will be utilized before default occurs. This conversion is based on historical borrower behavior and regulatory frameworks, ensuring the total potential risk is captured in the exposure calculation.

9. (B) Cohort LGD
Loss given default is calculated using specific methodologies based on available data and instrument types. Common approaches include the workout method using discounted cash flows, the market method based on defaulted bond prices, and the implied market method using asset pricing models. The cohort approach is typically used for transition matrices or probability of default rather than measuring specific instrument losses.

10. (C) EL is the average loss priced into yield, while UL is the loss volatility necessitating capital protection.
Expected loss and unexpected loss represent distinct aspects of credit risk measurement. Expected loss is the average anticipated loss which is typically managed through pricing and provisions from operating income. In contrast, unexpected loss reflects the volatility or deviation from the average. This potential for higher-than-expected losses necessitates the holding of capital to ensure the bank remains solvent.

11. (B) II, I, III
The Marginal Cost based Lending Rate framework requires a logical process to determine maturity buckets. Banks first identify if the single largest bucket contains more than thirty percent of funds. If not, they calculate cumulative weightage using a descending order of buckets. Finally, they arrive at a weighted average tenor of buckets that together represent more than thirty percent of funds.

12. (C) Probability of default, Loss given default, Exposure at default, and Effective maturity
Credit risk exposure is driven by several critical parameters that define the loss distribution. These primary drivers include the probability of default, which measures likelihood, and loss given default, which measures severity. Additionally, exposure at default quantifies the amount at risk, while effective maturity accounts for the time horizon of the exposure. These four factors form the measurement basis.

13. (A) All operating costs, including those recovered via service charges, must be included in the Operating Costs component of the MCLR.
When computing the Marginal Cost based Lending Rate, banks must follow specific inclusion rules. While general operating costs are included, any costs that the bank recovers separately through service charges are excluded from the operating cost component of the calculation. This prevents double counting and ensures the internal benchmark accurately reflects the net operational burden of the lending activities.

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14. (C) There is a higher chance of credit migration in the same direction than for opposite direction in consecutive years.
Credit rating transition matrices reveal how borrower credit quality changes over time. A common characteristic observed in these matrices is that credit migration tends to exhibit momentum. This means there is a statistically higher probability that a rating will move in the same direction in consecutive years compared to a reversal of direction, reflecting consistent improvements or deteriorations in credit.

15. (D) The bank must adopt a uniform external benchmark within a loan category.
For banks utilizing external benchmarks for floating rate personal or retail loans, transparency and uniformity are essential requirements. To ensure clarity for borrowers and consistency in pricing, a bank is required to adopt a single, uniform external benchmark within each specific loan category. This prevents confusion and allows for easier comparison of loan products across the financial market.

16. (A) The magnitude of likely loss on the exposure, expressed as a percentage of the exposure at default
Loss given default is a critical component used in the calculation of credit risk. It represents the magnitude of the loss the bank expects to incur on a specific exposure if a default event

to Statutory Liquidity Ratio reserves are not included in this calculation.

33. (A) P-2, Q-3, R-1, S-4
Multiple factors influence the recovery of funds and the resulting loss given default. Facility characteristics like loan size and fund-based status impact loss severity. Firm-specific capital structure, particularly leverage ratios, also plays a role. Furthermore, industry factors regarding asset reuse and macroeconomic variables such as GDP growth and unemployment rates capture the cyclical effects on the potential recovery of assets.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
In a standard credit transition matrix, most obligors are likely to maintain their current rating over a one-year period. This creates a high concentration of probability along the diagonal of the table. Consequently, as one moves away from the diagonal, the observation density decreases rapidly, as multi-notch rating changes are statistically less common than staying in the same grade.

35. (B) Only II
Management utilizes the concept of core risk level to guide decision-making during periods of high market volatility. When the market becomes abnormally volatile, the institution seeks to reduce its overall risk exposure to this core level. This strategic reduction helps to stabilize profitability by minimizing losses from non-core exposures, ensuring the bank continues to operate effectively as a going concern.

36. (A) ₹ 73.30 mln
Total exposure at default for a borrower is the sum of the individual exposure values for all facilities. In this scenario, the term loan and cash credit facilities have established exposures. Adding the performance bank guarantee, which uses a fifty percent conversion factor on its limit, results in a combined total exposure. The final calculated value for Goodluck Limited is 73.30 million.

37. (A) P-2, Q-4, R-1, S-3
Credit risk measurement relies on four fundamental elements. The probability of default indicates the likelihood of a counterparty failing. Loss given default represents the expected percentage loss if default occurs. Exposure at default quantifies the total amount of money at risk at the time of the event. Finally, maturity defines the time period during which the credit funds remain outstanding.

38. (C) I, II, and IV
A credit rating transition matrix summarizes the historical migration of borrower accounts between various credit grades. It provides a complete view of possible rating states over a set horizon. Typical observations show that density diminishes away from the diagonal. Furthermore, volatility in lower grades is often attributed to high-risk firms that either recover quickly or default, known as do-or-die entities.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Expected loss is defined as the anticipated average loss a bank expects to incur over a one-year horizon. Because it represents a predictable and normal cost of conducting lending business, it is not covered by capital. Instead, this loss should be priced into the loan yield and absorbed by the institution's operating income through the creation of standard financial provisions.

40. (D) WCTL is exempted only if granted outside of a formal rectification or debt restructuring package.
Bank regulations specify several exemptions from the Marginal Cost based Lending Rate framework. For example, advances to the bank's own employees and depositors against their deposits are exempted. Additionally, fixed rate loans with tenors over three years are also excluded. However, a Working Capital Term Loan is exempted only when it is granted as part of a formal restructuring package.

41. (B) ₹ 2.00 million
To calculate the expected loss of a specific loan transaction, the bank multiplies the exposure at default by the probability of default and the

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59. (B) I, III, IV, and V
Probability of default is a statistical measure of borrower failure likelihood over a specific period. It is never zero, as all borrowers carry some risk. Default probabilities generally increase over time due to uncertainty. Transition matrices characterize these changes in credit quality by summarizing how borrower accounts migrate between different grades, providing an essential tool for assessing historical portfolio credit performance.

60. (B) I and III only
Economic capital and regulatory capital provide different perspectives on a bank's financial strength. Economic capital is a forward-looking measure that uses the probability density function of credit losses to estimate the capital buffer needed for future risk shocks. In contrast, the regulatory Capital Adequacy Ratio is a static measure held on the specific day that the balance sheet is compiled.

61. (C) ₹ 31,00,00,000
To calculate economic profit, the bank must first determine the net income after accounting for expected losses. From this net income, the cost of the allocated economic capital is subtracted. This cost is found by multiplying the economic capital by the hurdle rate. Subtracting this twelve million capital charge from the forty-three million income results in a final economic profit of thirty-one million.

62. (A) UL will increase proportionally with the increase in LGD.
The formula for unexpected loss includes loss given default as a direct linear multiplier. Therefore, any change in the loss given default percentage has a proportional impact on the total unexpected loss calculation. If the loss given default increases due to a drop in collateral value, the unexpected loss will also increase proportionally, assuming that the other variables remain constant.

63. (C) $\sqrt{0.04 \times 0.96}$
The standard deviation of default for a transaction is a key component of the unexpected loss formula. It measures the volatility associated with the probability of default. The mathematical expression for this standard deviation is the square root of the product of the probability of default and its complement. For a four percent probability, this involves the square root of zero point zero four times zero point nine six.

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64. (C) 0.266%
Calculating the negative carry on the Cash Reserve Ratio requires applying a specific regulatory formula. This involves multiplying the required reserve ratio of four percent by the marginal cost of funds, which is six point four percent. The resulting value is then divided by the difference between one and the reserve ratio. This specific calculation yields a negative carry of zero point two six six percent.

65. (B) ₹ 43,00,00,000
Net income after expected losses is an important metric for evaluating portfolio performance. It is calculated by taking the net income generated before any losses and subtracting the estimated amount of expected loss. In this specific scenario, subtracting two million in expected losses from the forty-five million income before losses results in a net income after expected losses of forty-three million.

66. (D) ₹ 9.798 million
The unexpected loss for this specific loan is calculated by multiplying the exposure of two hundred million, the loss given default of twenty-five percent, and the standard deviation of default. The standard deviation is the square root of the default variance. Performing this multiplication results in an unexpected loss amount of nine point seven nine eight million for the credit transaction.

67. (D) 6.40%
The marginal cost of funds is a weighted average of the marginal cost of borrowings and the return on net worth. In this calculation, the borrowing cost of six percent is given a ninety percent weight, and the return on net worth of ten percent is given a ten percent weight. Combining these two components results in a total marginal cost of six point four percent.

68. (A) 53.75%
Risk-adjusted return on capital is a performance measure that relates income to the risk assumed.

50. (B) Only II
Several factors determine the loss given default for a credit exposure. Liquidity and seniority of collateral are major influences; more liquid and senior collateral typically leads to lower losses. Conversely, high leverage, represented by a low ratio of assets to liabilities, increases the loss. Industry competitiveness and asset reusability also affect liquidation values, with highly competitive industries often seeing lower recoveries.

51. (D) 45%
Loss given default is the portion of an exposure that a bank expects to lose if a borrower defaults. It is mathematically related to the recovery rate. Since the loss given default percentage is defined as one minus the recovery rate, a recovery rate of fifty-five percent implies that the bank will fail to recover forty-five percent of the total exposure.

52. (D) Cohort Approach — Removes firms whose ratings were withdrawn or migrated to Not Rated (NR) status from the sample.
Different approaches are used to analyze rating migration within transition matrices. The cohort approach tracks the observed proportions of ratings from the start to the end of a period. A specific procedural step in the cohort approach is the removal of firms from the sample if their ratings are withdrawn or if they migrate to a status of not rated.

53. (B) Only II
Under the external benchmark lending regime, specific rules govern how interest rates and spreads are managed. Banks are generally required to use a uniform benchmark within loan categories. Furthermore, the credit risk premium component of the spread is stable. It can only be changed if the borrower's credit assessment undergoes a substantial change, as previously agreed upon in the contract.

54. (D) Assertion (A) is false, but Reason (R) is true.
The cohort approach is a simplified method for constructing transition matrices. It does not track daily or intra-year rating fluctuations. Instead, it only compares the rating at the beginning of the observation period to the rating at the end. This means the assertion that it provides a detailed accounting of all intra-year fluctuations is false, while the reason describing its start-to-end nature is true.

55. (B) I, II, and IV
The Marginal Cost based Lending Rate system includes rules for spread management and formula components. The spread cannot be increased for existing borrowers unless their credit risk profile deteriorates. The business strategy component considers market competition and embedded options. Additionally, the negative carry on the Cash Reserve Ratio is calculated using the marginal cost and the specific reserve ratio in the formula.

56. (A) P-2, Q-1, R-4, S-3
MCLR and pricing involve several distinct components. Negative carry on the Cash Reserve Ratio occurs because mandatory reserves earn no interest. Operating costs encompass overheads like personnel and administrative expenses. Tenor premiums are added for longer-term commitments and are not borrower-specific. Finally, the credit risk premium compensates the bank for the default risk associated with the borrower's specific credit rating.

57. (A) ₹ 65.00 mln
For a term loan, the exposure at default is typically the current outstanding amount at the time of assessment. Although the limit for the facility might be lower, if the actual outstanding amount is sixty-five million, the bank is at risk for that entire amount. Therefore, the outstanding balance represents the most accurate measurement of the potential loss for this facility.

58. (C) Both I and II
In credit risk measurement, expected and unexpected losses represent different financial concepts. Expected losses are predictable average losses that should be covered by interest income and regular provisions. Unexpected losses represent the risk of actual losses exceeding those averages due to volatility. To remain solvent during such periods of high loss volatility, banks must maintain a sufficient level of capital protection.

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loss given default. For a loan of two hundred million with a four percent default probability and a twenty-five percent loss severity, the calculation results in an expected loss amount of exactly two million for the bank.

42. (C) P-4, Q-2, R-1, S-3
Risk management involves various mathematical expressions to quantify performance and risk. Expected loss is calculated as the product of exposure, default probability, and loss severity. Unexpected loss uses the square root of default variance. Economic capital or Value-at-Risk involves the tail of the distribution, while the risk-adjusted return on capital numerator accounts for income after costs and expected losses.

43. (B) I, II, and IV
Risk-adjusted return on capital is a framework for evaluating bank performance. It is based on the principle of charging a rational price for assumed risks. The methodology allocates more capital when the volatility of returns is higher. However, it does not suggest redeploying capital to under-performing areas; rather, it encourages moving capital away from activities that fail to meet targets.

44. (C) I and III only
Loss given default can be estimated using different techniques. The workout method focuses on the discounted cash flows recovered during the collection process. Alternatively, the market method observes the prices of marketable loans or defaulted bonds immediately following a default event. Both methods provide empirical data on recovery rates, whereas the implied market method relies on theoretical pricing of risky bonds.

45. (C) ₹ 6.80 mln
Calculating exposure at default for a cash credit facility involves considering both the outstanding balance and the undrawn limit. In this instance, the unused portion of the limit is multiplied by a twenty percent credit conversion factor. Adding this converted amount to the current outstanding balance of six million results in a total exposure at default of six point eight million.

46. (B) P-4, Q-2, R-1, S-3
Various methods exist to measure loss given default. Market loss given default is observed from the pricing of defaulted instruments. Workout loss given default is derived from discounted cash flows during recovery. The implied market method uses theoretical models on non-defaulted risky bonds. Finally, the loss given default percentage is simply calculated as one minus the overall recovery rate of the exposure.

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47. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
Estimating exposure at default is essential for both regulatory compliance and internal economic capital modeling. Credit exposure varies significantly across different products and is influenced by how borrowers utilize committed credit lines. While both statements regarding exposure importance and usage trends are factually correct, the borrower usage patterns do not serve as the primary explanation for why the estimation is necessary.

48. (B) Rating scale movement — As one goes down the rating scale, the probability of multi-notch movement rapidly decreases.
Transition matrices describe the stability of credit ratings over time. While the highest probability concentration is found on the diagonal, there is a distinct pattern as ratings decline. Contrary to being more stable, the probability of multi-notch rating movements actually increases for lower-rated obligors. Therefore, the statement that multi-notch movement probability rapidly decreases as one goes down the scale is incorrect.

49. (B) I, II, IV, and V
The Marginal Cost based Lending Rate framework includes several specific exemptions to its pricing rules. These exemptions apply to advances granted to the bank's own employees, including retired staff, and depositors against their own deposits. Furthermore, fixed rate loans with tenors exceeding three years and advances to the Chief Executive Officer or directors are also excluded from these internal benchmark provisions.

It is calculated by dividing the net income after expected losses by the total amount of economic capital allocated to the portfolio. For Portfolio Alpha, dividing forty-three million by eighty million results in a risk-adjusted return on capital of fifty-three point seven five percent.

69. (B) ₹ 2,00,00,000
Expected loss for a portfolio is determined by the product of three variables: the total balance, the probability of default, and the loss given default. For Portfolio Alpha, with a balance of two hundred million, a four percent default probability, and a twenty-five percent loss severity, the expected loss amount is calculated to be exactly two million.

70. (B) 8.466%
The final Marginal Cost based Lending Rate for the one-year tenor is the sum of its four regulatory components. These include the marginal cost of funds, the negative carry on the Cash Reserve Ratio, the operating cost, and the tenor premium. Adding these specific values together results in a final internal benchmark lending rate of eight point four six six percent.

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Assuming no other payments, what is the net settlement direction?
(A) Bank X pays Fund Y ₹ 70,000.
(B) Fund Y pays Bank X ₹ 70,000.
(C) Bank X pays Fund Y ₹ 170,000.
(D) Fund Y pays Bank X ₹ 120,000.

Oct/Nov 2019

50. Which of the following is NOT a constituent of the 'total return' transferred to the TR seller in a Total Return Swap (TRS)?
(A) Interest payments
(B) Change-in-value payments
(C) Legal costs of bankruptcy filing
(D) Fees

May/June 2021

51. Which of the following statements regarding Credit-Linked Notes (CLNs) is incorrect?
(A) CLNs are designed to resemble a synthetic corporate bond or loan.
(B) If the reference entity default, investors will receive proceeds only after the credit swap counterparty is paid the contingent payment.
(C) If the underlying collateral assets default, the investor is shielded from loss as long as the reference entity performs well.
(D) Investors are eligible to receive periodic coupons and face value at maturity, provided no credit event occurs.

Oct/Nov 2011

52. In a Credit Default Swap (CDS) transaction, if there is a maturity mismatch where the underlying loan is for five years but the CDS tenure is three years, what happens if a credit event occurs in the fourth year?
(A) The protection seller will still provide a payout because the underlying asset has a five-year maturity.
(B) The protection buyer automatically receives an extension of the CDS contract for two more years.
(C) The protection buyer is penalized and must refund the premium paid over the three years.
(D) The protection seller will not provide any payout as the CDS contract would have already expired.

NODIA

May/June 2005

53. Assume a bank buys defaulted bonds in the market at 60% of the notional value to physically deliver them to a protection seller in a Credit Default Swap (CDS) settlement. If the seller pays the full par value (100%) upon delivery, what is the bank's net gain from the derivative transaction itself (ignoring premium paid)?
(A) 60% of the notional value
(B) 40% of the notional value
(C) 100% of the notional value
(D) 20% of the notional value

Oct/Nov 2023

54. Match the credit option terms in List I with their functional descriptions in List II.
List I: (Terms)
P. Credit put option buyer
Q. Strike spread
R. Option seller (on exercise in asset swap)
S. Credit options usage
List II: (Descriptions)
1. Makes an upfront payment of par value for the combined package
2. Used for yield enhancement and hedging future borrowing costs
3. Pays a premium for the right to sell a specified reference asset
4. The predetermined spread received by the put seller plus the reference rate
(A) P-3, Q-4, R-1, S-2
(B) P-4, Q-3, R-2, S-1
(C) P-1, Q-2, R-3, S-4
(D) P-2, Q-1, R-4, S-3

May/June 2018

55. Which of the following statements regarding Total Return Swaps (TRS) is incorrect?
(A) The protection seller assumes the servicing and voting rights of the underlying asset upon entering the swap.
(B) TRS can be used as synthetic financing vehicles for the protection buyer to leverage their positions.
(C) In a TRS, the risk transfer is done with confidentiality and without going for an actual cash sale.
(D) TRS transactions inherently result in counterparty risk because of the ongoing periodic exchange of cash flows.

(D) Deliverable Obligation — An obligation that strictly forbids asset settlement.

May/June 2012

7. Arrange the following steps in the conceptual sequence of developing a credit derivative instrument as an act of financial innovation:

I. Repackaging the components into a new contract

II. Starting with a traditional financial contract

III. Unbundling various components from the contract

(A) II, III, I
(B) I, II, III
(C) III, II, I
(D) II, I, III

Oct/Nov 2019

8. Match the feature (List I) with its specific descriptive category (List II).

List I: (Feature)

P. Ability to underwrite more and increase credit capacity

Q. Earning non-funded income in lieu of understanding risks better

R. Asset remains on the balance sheet earning income

S. Actual cash needs to be deployed only if triggered

List II: (Descriptive Category)

1. Protection Buyer Advantage: Risk Transfer
2. Protection Buyer Advantage: Asset Retention
3. Protection Seller Advantage: Income Generation
4. Protection Seller Advantage: Capital Efficiency

(A) P-1, Q-3, R-2, S-4
(B) P-2, Q-4, R-1, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2021

9. In the context of credit events, what primarily determines when the payment under a credit derivative is made?

(A) The expiration of the underlying asset's original maturity date after all scheduled payments are completed.

(B) The trigger of a credit event denoting a deterioration in credit quality that impairs repayment capacity.

(C) The voluntary decision of the protection seller to close the contract based on current market sentiment.

(D) The quarterly financial reporting cycle of the reference entity as mandated by the relevant stock exchange.

Oct/Nov 2011

10. Which of the following is generally NOT considered a credit asset whose risks are commonly transferred through credit derivatives?

(A) Small and medium enterprise (SME) loans
(B) Automobile leases and vehicle finance agreements
(C) Commodities and real estate holdings
(D) Sovereign debt obligations and government bonds

May/June 2005

11. Consider the following statements regarding Credit Default Swaps (CDS):

I The contingent payment in a CDS is calculated as the decrease in the value of the reference obligation below the par value at a pre-designated time.

II Most reference assets maintain a highly deterministic market value immediately following a credit event.

Which of the statements is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

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Oct/Nov 2023

12. In a credit derivative transaction, how is the pricing structured?

(A) The cost is fixed by the regulatory authority regardless of underlying risks.

(B) The premium is strictly equal to the par value of the reference obligation.

(C) The cost is linked to the riskiness of the underlying asset, with the premium charged accordingly.

(D) The cost is entirely borne by the reference entity through a series of mandatory administrative fees.

Oct/Nov 2012

38. In a Total Return Swap (TRS), how are payments handled if the reference asset's market value declines significantly?

(A) The protection buyer must increase their premium payments to the TR seller to compensate for losses.

(B) The TR seller will receive a compensatory payout from the protection buyer to offset market depreciation.

(C) The contract is automatically converted into a Credit Default Swap (CDS) to address the credit deterioration.

(D) If there is a net depreciation in value, the protection buyer will receive payment from the seller.

May/June 2022

39. Consider the following statements regarding Credit Options:

I A credit put option provides the buyer the right to sell a reference asset at a pre-specified exercise price.

II A credit call option provides the buyer the right to buy a reference asset from the option seller.

III Credit options are available strictly for floating rate notes and cannot be used on loan or asset swap packages.

IV Settlement of credit options can be through cash or delivery of a physical asset.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (IV) only

(B) (I), (III), and (IV) only

(C) (II), (III), and (IV) only

(D) (I), (II), and (III) only

Oct/Nov 2010

40. In a three-year Credit Default Swap (CDS) contract, what occurs at the end of the term if no credit event materializes?

(A) The protection buyer receives a full refund of all premiums paid over the three years as a performance bonus.

(B) The protection seller assumes legal ownership of the underlying secured loan to improve their asset portfolio.

(C) The contract automatically renews for the remaining term of the loan without any further premium payments required.

(D) The contract expires, and the protection buyer retains the loan having paid the periodic premium for protection.

May/June 2007

41. The "dual risk" assumed by an investor in a Credit-Linked Note (CLN) does NOT encompass which of the following?

(A) The specific credit risk associated with the reference entity.

(B) The operational risk of the swap counterparty executing the trade.

(C) The credit risk of the underlying collateral assets held by the SPV.

(D) The risk that the reference entity defaults on its debt obligations.

Oct/Nov 2013

42. In a Credit Default Swap (CDS) transaction, a bank holds a secured loan but buys protection referenced against the company's senior unsecured loans. Why does this typically create stronger protection for the bank?

(A) Because unsecured loans typically have lower yields and are easier to physically deliver during settlement.

(B) Because secured loans cannot be legally delivered in an asset settlement process due to regulatory hurdles.

(C) Because market trades focus on unsecured general credit risk, where defaults are more likely to occur.

(D) Because protection sellers are legally prohibited from accepting secured loans as part of a settlement agreement.

May/June 2017

43. Given below are two statements, one labelled as Assertion (A) and the other labelled as Reason (R):

Assertion (A): In a Total Return Swap, the protection buyer retains the servicing and voting rights to the underlying asset.

Reason (R): The risk transfer is achieved synthetically and confidentially without the actual cash sale of the asset.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is

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V Failure to pay

Which of the above events are commonly included as mutually agreed triggers in a credit derivative contract?

(A) (I), (II), (III), and (V) only
(B) (I), (III), (IV), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2025

20. Consider the following statements regarding credit derivatives:

I In an unfunded credit derivative, the protection seller makes no financial investment until a credit event occurs.

II A credit derivative is strictly an unfunded product and cannot be converted into a funded product by the parties.

Which of the statements is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2019

21. Identify the correct statement regarding compensatory loss payments in a Credit Default Swap (CDS).

(A) The protection buyer must submit definitive proof of actual financial loss to receive any contingent payment.
(B) The protection buyer must physically deliver the asset even if cash settlement is the agreed method.
(C) The protection buyer does not necessarily have to suffer losses to receive contingent payments.
(D) The protection seller is legally bound to directly reimburse the reference entity.

Oct/Nov 2006

22. Which of the following best describes the primary utility of credit derivatives?

(A) They are primary tools for physical asset delivery.
(B) They are effective risk sharing instruments.
(C) They are exclusively speculative vehicles for retail investors.
(D) They are mandatory provisions for issuing corporate loans.

May/June 2010

23. Read the following statements and select the correct option:

Assertion (A): Buying protection in a credit derivative is similar to going short on the bond.

Reason (R): The protection buyer shortens the exposure on the entity because they gain if the credit quality of the reference asset decreases.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2024

24. Which of the following is the most appropriate reason for including the notion of 'materiality' in the definition of a credit event?

(A) To ensure that the protection buyer receives a payout irrespective of the underlying asset's market value.
(B) To guarantee that all rating downgrades automatically trigger a physical settlement process between the parties.
(C) To allow the protection seller to unilaterally cancel the derivative contract if the reference entity remains stable.
(D) To prevent declaring a credit event for minor occurrences that do not significantly influence the asset's value.

May/June 2016

25. Consider the following statements regarding the advantages of credit derivatives to the protection buyer:

I The protection buyer significantly reduces their credit portfolio risk.

II The protection buyer is forced to remove the asset from their balance sheet immediately.

III The protection buyer may increase credit capacity as overall credit risk reduces.

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (I) and (III) only

NODIA

(C) (II) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2005

26. Historically, what was the primary reason banks engaged in selling credit risk through credit derivatives in the 1990s?
(A) To deliberately decrease their credit volume and conserve capital reserves for future international expansions.
(B) To inform corporate clients that their credit limits had been breached following internal auditing reviews.
(C) To directly fund the expansion of small and medium enterprises through unsecured and non-collateralized loans.
(D) To extend credit to important clients after reaching exposure limits by hedging the embedded credit risk.

May/June 2020

27. Which of the following accurately defines a Credit Default Swap (CDS)?
(A) A contract where the buyer pays a periodic fee for a contingent payment from the seller upon a credit event.
(B) A contract where the protection seller pays a periodic fee to assume the market risk of an underlying equity asset.
(C) A unilateral agreement ensuring that a borrower repays their debt in exchange for a transfer of equity shares.
(D) A total exchange of economic performance of one asset for cash flows of another without any credit event contingency.

Oct/Nov 2015

28. Which of the following correctly describes the position of a protection buyer?
(A) Buying protection is like going short on the bond, gaining if the credit quality of the reference asset decreases.
(B) Buying protection is like going long on the bond, gaining when credit quality improves and market yields drop.
(C) Buying protection ensures an absolute elimination of all counterparty risk during the contract period.
(D) Buying protection guarantees that the underlying asset is removed from the buyer's balance sheet for accounting.

May/June 2013

29. Match the terms in List I with their corresponding descriptions in List II regarding credit derivatives.
List I: (Terms)
P. Materiality
Q. Payout
R. Credit Event
S. Reference Asset
List II: (Descriptions)
1. Activated by its occurrence
2. Key element intended to preclude declaring a credit event for non-influential events
3. Usually activated by the occurrence of a credit event
4. The underlying obligation whose credit risk is transferred
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2021

30. Which of the following correctly pairs the participant with its typical motivation or characteristic in a credit derivative transaction?
(A) Protection Buyer — Motivated by yield enhancement from synthetic exposures
(B) Reference Entity — Pays the periodic premium to the protection seller
(C) Hedge Fund — Seeks to hedge inherent credit risks in its existing originated loan portfolio
(D) Protection Seller — Usually hedge funds or insurance companies seeking yield

May/June 2024

31. In a Credit Default Swap (CDS) transaction where protection is bought against senior unsecured bonds, if the reference entity defaults on a different senior unsecured bond it issued but continues to service the buyer's specific secured loan, what will be the result?
(A) No credit event is triggered because the buyer's specific loan is still performing according to terms.
(B) The contract is nullified, and premium payments are paused until the company resolves its liquidity issues.
(C) A credit event is triggered if the default occurred on an obligation satisfying the reference characteristics.

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(D) The protection buyer must immediately recall its performing loan to mitigate potential future financial losses.

Oct/Nov 2008

32. Consider the following statements about Total Return Swaps (TRS):

I A total return swap can be viewed as an instrument providing synthetic financing to the protection seller to gain exposure to the reference obligation.

II Total return swaps eliminate all counterparty risk because control of the asset remains with the protection buyer.

Which of the statements is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2008

33. Consider the following statements regarding asset (physical) settlement in a Credit Default Swap (CDS):

I The asset that can be delivered is known as the deliverable obligation.

II The protection buyer is restricted to delivering only the specific original loan that triggered the event.

III Asset settlement is more common when the counterparty can hold and take the defaulted asset through the bankruptcy process.

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2017

34. Identify the correct statement regarding credit options on asset swap packages.

(A) The put buyer receives the premium and pays the strike spread to the option seller.
(B) The put seller receives the coupon on the reference asset and pays the reference rate only.
(C) The put buyer makes an upfront payment of the par value upon exercise of the option.
(D) The put seller pays the asset coupon and receives the reference rate plus the strike spread.

May/June 2011

35. Which of the following highlights the primary conceptual difference between a Total Return Swap (TRS) and a Credit Default Swap (CDS)?

(A) A TRS exchanges economic performance regularly, while a CDS triggers cash exchange only upon a credit event.
(B) A TRS transfers only interest rate risk, whereas a CDS transfers only foreign exchange risk across markets.
(C) A TRS requires physical delivery of the asset at inception, whereas a CDS requires cash settlement upon maturity.
(D) A TRS is an unfunded instrument, whereas a CDS is strictly a funded balance sheet asset for the bank.

Oct/Nov 2020

36. What is the most appropriate reason that Credit-Linked Notes (CLNs) generally offer a higher yield?

(A) Because investors assume dual credit risk—of both the reference entity and the collateral assets.
(B) Because they are exclusively issued by sovereign governments to fund large-scale infrastructure projects.
(C) Because they are unfunded assets that require no initial principal outlay by the investor at inception.
(D) Because the collateral securities are entirely immune to market risk and interest rate fluctuations.

May/June 2015

37. A bank enters into a Credit Default Swap (CDS) as a protection buyer for a notional value of ₹ 5 million. The premium agreed upon is 80 basis points. What is the annual premium amount to be paid to the protection seller?

(A) ₹ 40,000
(B) ₹ 80,000
(C) ₹ 4,000
(D) ₹ 400,000

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May/June 2018

13. Identify the correct statements regarding the advantages to the protection seller:

I Offers the opportunity to earn non-funded income.

II The investment remains off-balance sheet until a credit event is triggered.

III Overall transaction costs tend to be relatively higher than direct investment.

IV Overall return could exceed that of the direct investment.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (IV) only
(B) (I), (II), and (III) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

Oct/Nov 2016

14. Which of the following statements regarding the protection seller is incorrect?

(A) The protection seller may expect the credit quality of the reference credit asset to improve.
(B) The credit derivative could be either a funded or an unfunded product for the protection seller.
(C) An unfunded credit derivative requires the seller to make a massive financial investment before a credit event.
(D) The parties may often convert a credit derivative into a funded product through a formal restructuring process.

May/June 2014

15. In a Credit Default Swap (CDS), the periodic fee paid by the protection buyer is typically expressed in which format?

(A) As a fixed percentage of the market capitalization.
(B) As a one-time upfront lump sum payment equivalent to the bond's par value.
(C) In basis points per month on the depreciated market value.
(D) In basis points per annum on a notional amount.

Oct/Nov 2007

16. Which of the following provides the precise definition of a derivative?

(A) A bilateral contract shifting risk from one party to another, with value derived from an underlying reference asset.
(B) A unilateral agreement transferring assets based on fluctuating price movements of specific capital market securities.
(C) An agreement designed explicitly to shift credit performance from a reference entity to a designated premium buyer.
(D) A regulatory framework dictating the risk premium charged for capital market transactions by international banks.

May/June 2009

17. Given below are two statements, one labelled as Assertion (A) and the other labelled as Reason (R):

Assertion (A): The notion of 'materiality' is a crucial element in defining a credit event within a credit derivative contract.

Reason (R): It precludes either party from declaring a credit event when an occurrence does not materially influence the value of the reference asset.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2018

18. Which of the following constitute the major credit assets in over-the-counter transactions for credit derivatives?

(A) Corporate loans, bonds, and sovereign debt obligations.
(B) Equity funds, mutual funds, and exchange-traded portfolios.
(C) Auto leases, SME loans, and commercial hire-purchase agreements.
(D) Diversified loan pools, index trades, and retail banking accounts.

May/June 2023

19. Consider the following credit events:

I Restructuring of the debt

II Rating downgrades to unacceptable levels

III Cross default clause triggered credit event

IV Bankruptcy or moratorium

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false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2022

44. Match the concept with its accurate description in a Total Return Swap (TRS) and Credit Default Swap (CDS).
List I: (Concept)
P. Total Return Swap Payment
Q. CDS Payment
R. Change-in-value payment
S. Total Return
List II: (Description)
1. Takes place only when a credit event occurs
2. Equal to the depreciation or appreciation in the market value
3. Based on changes in market valuation over the agreement period
4. Comprises interest, fees, and change-in-value payments
(A) P-3, Q-1, R-2, S-4
(B) P-1, Q-3, R-4, S-2
(C) P-4, Q-2, R-1, S-3
(D) P-2, Q-4, R-3, S-1

May/June 2006

45. Consider the following characteristics of Credit-Linked Notes (CLN):
I They are funded balance sheet assets.
II They are typically issued by a special purpose vehicle (SPV).
III The SPV holds collateral securities financed through the issue of notes to investors.
IV Investors face the single credit risk of the reference entity only.
V They offer synthetic credit exposure to a reference entity.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III), and (V) only
(B) (I), (II), and (III), and (IV) only
(C) (II), (III), (IV), and (V) only
(D) (I), (III), (IV), and (V) only

Oct/Nov 2014

46. Alpha Bank is the protection buyer in a Credit Default Swap (CDS) with a notional value of ₹ 50 million. A credit event occurs, and the parties opt for physical (asset) settlement. What action will Alpha Bank take to settle the contract?
(A) Alpha Bank will receive the depreciated market value in cash and retain ownership of the reference assets.
(B) Alpha Bank will deliver the defaulted obligations to the protection seller and receive the par value in cash.
(C) Alpha Bank will pay the protection seller the difference between the current par value and the market value.
(D) Alpha Bank will surrender the CDS premium back to the protection seller to finalize the termination process.

May/June 2025

47. Which of the following is an INCORRECT pairing regarding Credit Options?
(A) Credit Put Option — Right to sell a specified reference asset
(B) Credit Call Option — Right to buy a specified reference asset from a counterparty at a fixed price
(C) Option Settlement — Exclusively restricted to physical asset delivery
(D) Application of Credit Options — Hedging future borrowing costs

Oct/Nov 2009

48. What is a potential strategic reason for an entity to act as a protection seller in a Credit Default Swap (CDS)?
(A) To eliminate all default risk associated with the reference entity from its portfolio of credit assets.
(B) To create synthetic exposure or profit if the cost of buying protection declines in the future.
(C) To physically acquire the protection buyer's secured loan immediately through a mandatory purchase agreement.
(D) To fulfill regulatory capital requirements for non-funded balance sheet items as per international standards.

May/June 2012

49. Bank X (protection buyer) and Fund Y (TR seller) enter into a Total Return Swap. During the first settlement period, the reference asset generates ₹ 50,000 in interest and fees, but suffers a market depreciation of ₹ 120,000.

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CHAPTER 12
Credit Derivatives

May/June 2017

1. Who is a protection buyer in a credit derivative transaction?

(A) An entity that assumes the credit risk of the underlying debt obligations.

(B) An investor who purchases the defaulted asset from the bankruptcy court.

(C) A special purpose vehicle that issues funded balance sheet assets.

(D) An entity that seeks protection against the risk of default of the reference obligation.

Oct/Nov 2022

2. Which of the following is NOT an advantage to the protection seller in a credit derivative transaction?

(A) The strategic opportunity to earn consistent non-funded income over the life of the contract.

(B) The investment remains off-balance sheet for the seller until a credit event is formally triggered.

(C) The asset remains on the seller's balance sheet earning continuous interest income.

(D) Overall transaction costs tend to be relatively lower than those associated with direct cash investment.

May/June 2006

3. What is a credit derivative?

(A) An instrument used for hedging the equity performance of sovereign entities in the emerging market sectors.

(B) An insurance contract guaranteeing the exact recovery of losses from non-funded credit assets and liabilities.

(C) A contract shifting credit risk between parties, with value derived from the credit performance of a reference entity.

(D) A funding mechanism providing direct capital to the protection buyer to increase their total liquidity levels.

Oct/Nov 2014

4. Which of the following statements regarding the applicability of credit derivatives is incorrect?

(A) A credit derivative can be structured around a single credit asset if it is deemed to be sufficiently large.

(B) A credit derivative can be taken on a collection or pool of credit assets within a specific industry sector.

(C) Transferring credit risk is strictly prohibited for pools of assets and only possible for large individual exposures.

(D) Transferring the credit risk of large exposures can favorably impact the overall credit portfolio of a bank.

May/June 2025

5. What is the primary motivation for an entity to act as a protection seller?

(A) To eliminate all counterparty risk from their existing portfolio of diversified fixed income assets.

(B) To achieve yield enhancement or gains from synthetic exposures where creating a direct loan portfolio is not feasible.

(C) To gain protection against the default of their own reference assets through a series of internal transfers.

(D) To convert unfunded credit derivatives into equity shares of the reference entity at a predetermined conversion rate.

Oct/Nov 2009

6. Which of the following correctly pairs a CDS component with its characteristic?

(A) Premium — Calculated based solely on the post-default deterministic market value.

(B) Notional Value — The reference value for computing the premium and protection contingency payment.

(C) Contingent Payment — A guaranteed periodic payment made by the protection seller regardless of a credit event.

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Oct/Nov 2016

56. In a scenario where ABC Bank provides a loan of ₹ 120 million to a company but enters into a Credit Default Swap (CDS) for a notional value of ₹ 100 million, what does this discrepancy signify regarding ABC Bank's risk position?

(A) ABC Bank remains exposed to ₹ 20 million of unhedged credit risk on the loan.

(B) ABC Bank has fully hedged its exposure and transferred ₹ 20 million to the reference entity.

(C) The protection seller has over-collateralized the transaction by ₹ 20 million.

(D) The contract is invalid due to the mismatch in notional value and loan amount.

May/June 2014

57. If a corporate treasury buys a credit put option on an asset swap package and decides to exercise it due to asset deterioration, what is the put seller immediately obligated to do upon exercise?

(A) Make an upfront payment of par value for the combined package to the corporate treasury.

(B) Pay only the strike spread to the corporate treasury to settle the interest rate differential.

(C) Deliver the physical reference asset to the corporate treasury to fulfill the swap requirement.

(D) Refund the premium paid by the corporate treasury at the inception of the option contract.

Oct/Nov 2007

58. If a credit event occurs and physical settlement is executed in a Credit Default Swap (CDS), how does the exchange typically happen between the protection buyer and the protection seller?

(A) The buyer delivers a qualifying bond and receives the notional value in cash from the seller.

(B) The seller delivers a specific value of the reference entity's equity to the buyer as compensation.

(C) The buyer delivers its entire original loan and receives the notional value in return from the counterparty.

(D) The seller pays the buyer the difference between the actual loan market value and the agreed notional value.

May/June 2009

59. A protection buyer in a Total Return Swap (TRS) opts to settle the change-in-value at maturity via delivery. How will the final exchange be executed?

(A) The buyer delivers the reference obligation and receives the current depreciated market value in cash from the seller.

(B) The seller delivers a different reference asset of equivalent initial value to settle the outstanding balance.

(C) The buyer delivers the reference obligation and receives a payment equal to the asset's initial value.

(D) The buyer pays the initial value and receives the physical asset back from the swap counterparty.

Oct/Nov 2018

60. In a Total Return Swap (TRS), what components make up the 'total return' paid by the protection buyer to the TR seller?

(A) Principal repayment, compound interest, and penalty fees.

(B) Interest payments, fees, and change-in-value payments.

(C) Dividend yields, equity appreciation, and voting rights premiums.

(D) CDS premium, default loss compensation, and par value.

May/June 2023

61. Match the Key Definitions in List I to their exact conceptual meaning in List II.

List I: (Term)

P. Protection seller

Q. Credit event

R. Credit-linked notes

S. Payout

List II: (Meaning)

1. Funded balance sheet assets offering synthetic credit exposure via a structure resembling a corporate bond.
2. The party to a CDS contract that agrees to assume or guarantee credit risk.
3. A financial event where a borrower's financial situation changes negatively affecting creditworthiness.
4. Usually activated by the occurrence of a credit event that affects the credit status

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of the reference asset.
(A) P-1, Q-3, R-2, S-4
(B) P-2, Q-3, R-1, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2025

62. Given below are two statements, one labelled as Assertion (A) and the other labelled as Reason (R):
Assertion (A): Credit-Linked Notes generally provide a higher yield compared to the standalone yield on the underlying collateral.
Reason (R): Investors in a Credit-Linked Note are compensated for assuming the dual credit risk of both the reference entity and the underlying collateral assets.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2019

63. An investor holds a Credit-Linked Note (CLN). A credit event occurs causing the reference entity to default. The SPV liquidates the collateral which yields ₹ 10 million. The contingent payment owed to the credit swap counterparty is ₹ 4 million. What proceeds are available to the investors?
(A) ₹ 10 million
(B) ₹ 14 million
(C) ₹ 6 million
(D) ₹ 0

Oct/Nov 2006

64. Consider the following statements regarding the characteristics of credit derivatives:
I They can de-couple credit risk from funding.
II They require entities to actually sell bonds in the secondary market to alter risk exposure.
III They allow entities to alter credit risk exposure without buying or selling loans.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

May/June 2010

65. Consider the following entities:
I Banks and security houses
II Monoline insurers and insurance companies
III Hedge funds and pension funds
IV Microfinance retail borrowers
Which of the above entities are identified as major users of credit derivatives?
(A) (I), (II), and (IV) only
(B) (I), (II), and (III) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

Oct/Nov 2024

66. An investor holds a Credit-Linked Note (CLN) referenced to Company A. Company A is performing perfectly. However, the SPV's underlying collateral assets unexpectedly default and lose 50% of their value. What is the impact on the CLN investor?
(A) The investor receives full payout because Company A has not triggered a credit event in the market.
(B) The credit swap counterparty must compensate the investor for any collateral shortfall that may occur.
(C) The SPV must issue additional notes to cover the collateral deficit and protect the investor's principal.
(D) The investor suffers a loss based on the collateral's recovery, despite Company A's performance.

May/June 2016

67. Which of the following terms is incorrectly paired with its description?
(A) Credit Default Swap — A bilateral contract where the protection buyer pays a periodic fee for a contingent payment following a credit event.
(B) Protection Buyer — An entity that seeks protection against the risk of default of the reference obligation.
(C) Credit Event — An event that strictly guarantees the improvement of a borrower's creditworthiness.

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(D) Credit Derivatives — Agreements that can de-couple credit risk from funding without actually buying or selling bonds.

Oct/Nov 2005

68. Consider the following products:

I Basket products
II Equity-linked credit products
III Synthetic CDOs
IV Swaptions
V Tranched index trades

Which of the above are included in the typical product range of credit derivatives?

(A) (I), (II), (III), and (V) only
(B) (II), (III), (IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

May/June 2020

69. Arrange the following steps chronologically for an asset (physical) settlement in a Credit Default Swap (CDS) transaction:

I. The protection buyer receives the par value of the delivered asset.
II. A credit event occurs concerning the reference entity.
III. The protection buyer physically delivers the defaulted deliverable obligations to the seller.

(A) II, III, I
(B) III, II, I
(C) I, II, III
(D) II, I, III

Oct/Nov 2015

70. Which of the following is the most appropriate foundational requirement for the functioning of credit derivatives?

(A) The guaranteed physical possession of the underlying collateral by the buyer.
(B) The risk assessment capability of the protection seller prepared to take the risk.
(C) The absolute elimination of counterparty risk through regulatory fiat.
(D) The issuance of a syndicated loan to support the funding of the reference entity.

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the deliverable asset is a key feature of standard credit derivative documentation.

34. (D) The put seller pays the asset coupon and receives the reference rate plus the strike spread.
When a credit put option on an asset swap package is exercised, the seller assumes the position of the asset holder. They are obligated to pay the coupon from the reference asset to the swap counterparty. In return, the seller receives a floating reference rate plus a predetermined strike spread, effectively taking over the risk of the asset at a fixed spread.

35. (A) A TRS exchanges economic performance regularly, while a CDS triggers cash exchange only upon a credit event.
The primary distinction lies in the payment triggers. A Total Return Swap involves the ongoing exchange of all cash flows, including interest, fees, and value changes, throughout the life of the contract. In contrast, a Credit Default Swap is a contingent instrument where payments from the seller are only made if a specific credit event, such as a default, occurs.

36. (A) Because investors assume dual credit risk—of both the reference entity and the collateral assets.
Credit-Linked Notes carry higher yields because they expose investors to two layers of risk. First is the credit risk of the reference entity. Second is the credit risk of the collateral assets held by the Special Purpose Vehicle. If either the reference entity or the collateral defaults, the investor may lose their principal, necessitating a higher risk premium for the trade.

37. (A) ₹ 40,000
The annual premium is calculated by multiplying the notional value by the agreed basis points. For a notional value of ₹ 5,000,000 and a premium of 80 basis points (0.80% or 0.0080), the calculation is 5,000,000 multiplied by 0.0080. This results in an annual payment of ₹ 40,000, which the protection buyer must pay to the seller for the coverage provided.

38. (D) If there is a net depreciation in value, the protection buyer will receive payment from the seller.
In a Total Return Swap, the protection buyer pays the "total return" to the seller. Conversely, the seller must compensate the buyer for any depreciation in the asset's market value. If the asset's price falls, the seller pays the buyer the difference, ensuring the buyer is hedged against the decline in the asset's value over the agreement period.

39. (A) (I), (II), and (IV) only
Credit put options give the right to sell an asset, while call options give the right to buy. These can be settled via cash or physical delivery. However, they are not limited to floating rate notes and are frequently used on various instruments, including loan packages and asset swaps. This flexibility makes them useful for managing price risk and future borrowing costs.

40. (D) The contract expires, and the protection buyer retains the loan having paid the periodic premium for protection.
If no credit event occurs during the term of a CDS, the contract simply expires at maturity. The protection buyer does not receive any refund of the premiums paid, as those were the cost of the protection provided. The buyer continues to hold the underlying loan, and the protection seller keeps the accumulated premium as profit for the risk assumed.

41. (B) The operational risk of the swap counterparty executing the trade.
Dual risk in a Credit-Linked Note refers specifically to credit risks: the risk that the reference entity defaults and the risk that the collateral assets fail. While operational risks exist in all financial transactions, they are not part of the "dual credit risk" structure that investors are compensated for through higher yields in the design of these specialized financial notes.

42. (C) Because market trades focus on unsecured general credit risk, where defaults are more likely to occur.
Market liquidity for Credit Default Swaps is highest for senior unsecured obligations. These instruments represent the general

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assuming risk, and capital efficiency allows them to participate without immediate cash deployment. These advantages differentiate the roles and motivations of both parties involved in a standard credit derivative transaction within the current financial system.

9. (B) The trigger of a credit event denoting a deterioration in credit quality that impairs repayment capacity.
The timing of a payout in a credit derivative is contingent upon the occurrence of a predefined credit event. These events signal a significant negative change in the borrower's financial health, such as bankruptcy or failure to pay. Once a credit event is formally triggered and verified by the parties, the protection seller is obligated to provide the compensatory payment.

10. (C) Commodities and real estate holdings
Credit derivatives focus on transferring the risk of default associated with debt-based obligations. Common assets include corporate loans, bonds, sovereign debt, and SME financing. While commodities and real estate involve significant market risks, they are typically handled through other types of derivatives like futures or swaps, rather than credit-specific instruments that target the repayment capacity of a specific debtor.

11. (A) Only (I)
In a Credit Default Swap, the contingent payment is designed to cover the loss in value of the reference asset following a default. This is often calculated based on the difference between the par value and the recovery value. Post-default market values are typically non-deterministic and highly volatile, making the second statement regarding high determinism inaccurate in market practice.

12. (C) The cost is linked to the riskiness of the underlying asset, with the premium charged accordingly.
The premium in a credit derivative is essentially the cost of insurance against default. This price is determined by the market's perception of the reference entity's creditworthiness. Riskier assets command higher basis points because the probability of a credit event is greater. This market-driven pricing ensures that the protection seller is adequately compensated for the specific risk they assume.

13. (A) (I), (II), and (IV) only
Protection sellers benefit from earning non-funded income while keeping the investment off-balance sheet until a trigger event occurs. Furthermore, the synthetic nature of the trade may allow for higher overall returns compared to direct investment. However, a major advantage is that transaction costs for derivatives are generally lower than direct cash investments, making the third statement about costs incorrect.

14. (C) An unfunded credit derivative requires the seller to make a massive financial investment before a credit event.
An unfunded credit derivative is specifically designed to avoid an upfront principal investment. The protection seller only makes a payment if a predefined credit event occurs. This feature provides significant leverage and capital efficiency, as no large financial outlay is required at the inception of the contract, unlike funded instruments where the principal is paid at the start of the trade.

15. (D) In basis points per annum on a notional amount.
The pricing of a Credit Default Swap is standardized as an annualized fee. This fee is expressed in basis points, where one basis point equals one-hundredth of a percent. This rate is applied to the notional amount of the contract to determine the regular cash payments the protection buyer must make to the protection seller for the provided coverage.

16. (A) A bilateral contract shifting risk from one party to another, with value derived from an underlying reference asset.
A derivative is a financial instrument that facilitates the transfer of risk between two parties. Its primary characteristic is that its value is not intrinsic but is derived from the performance or price movements of an underlying reference asset, such as a bond, loan, or index. These contracts allow for efficient risk management without necessitating the physical transfer of the assets.

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17. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Materiality is essential in credit derivative contracts to define what constitutes a valid trigger. It ensures that only significant financial deteriorations that affect the asset's value lead to a payout. By including materiality clauses, parties prevent the declaration of credit events for minor or technical defaults that do not reflect a genuine impairment of the debtor's overall repayment capacity.

18. (A) Corporate loans, bonds, and sovereign debt obligations.
The over-the-counter credit derivatives market primarily deals with high-value debt instruments. Corporate bonds and loans represent the bulk of the market, allowing banks to manage exposure to specific companies. Sovereign debt is also frequently used for hedging against national economic instability. These assets have clearly defined credit profiles suitable for the specialized nature of these over-the-counter derivative contracts.

19. (B) (I), (III), (IV), and (V) only
Standard credit events in derivative contracts include bankruptcy, failure to pay, debt restructuring, and cross-default triggers. These represent clear instances of credit failure. While rating downgrades indicate increased risk, they are often excluded as formal triggers because they are opinions of third-party agencies and do not always constitute a legal default or immediate impairment of the borrower's repayment capability.

20. (A) Only (I)
Unfunded credit derivatives allow protection sellers to assume risk without providing upfront capital, only paying out upon a credit event. This is a defining characteristic of instruments like Credit Default Swaps. Contrary to being strictly unfunded, these instruments can indeed be converted into funded products, such as Credit-Linked Notes, through structured financial arrangements involving special purpose vehicles and collateral.

21. (C) The protection buyer does not necessarily have to suffer losses to receive contingent payments.
A Credit Default Swap is a derivative contract rather than an insurance policy. Consequently, the protection buyer is entitled to the contingent payment once a credit event is triggered, regardless of whether they actually hold the underlying debt or suffered a physical loss. This feature allows for the use of credit default swaps for both hedging and speculative investment purposes.

22. (B) They are effective risk sharing instruments.
The core function of credit derivatives is to facilitate the efficient sharing and distribution of credit risk throughout the financial system. They allow institutions to transfer specific risks to parties better equipped or more willing to bear them. This enhances market liquidity and enables banks to manage their portfolios and capital requirements without liquidating underlying loan or bond positions.

23. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Purchasing credit protection is functionally equivalent to taking a short position on a bond. In both scenarios, the investor profits when the credit quality of the reference entity declines or a default occurs. The protection buyer benefits from the contingent payment, which increases in value as the probability of default rises, effectively shortening their overall exposure to the reference entity.

24. (D) To prevent declaring a credit event for minor occurrences that do not significantly influence the asset's value.
Materiality thresholds are designed to protect the integrity of credit derivative contracts. They ensure that technical glitches or minor payment delays do not trigger large payouts. By requiring a significant impact on the asset's value, materiality clauses ensure that the contract responds only to genuine credit deterioration, providing stability and fairness for both the protection buyer and the seller.

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25. (B) (I) and (III) only
Credit derivatives allow buyers to reduce portfolio risk while keeping the assets on their balance sheet. This retention is a key benefit, as it preserves client relationships. By hedging the risk, the buyer also increases their credit capacity, allowing for further lending. The second statement is incorrect because the asset is not forced off the balance sheet during a hedge.

26. (D) To extend credit to important clients after reaching exposure limits by hedging the embedded credit risk.
During the 1990s, banks faced regulatory and internal limits on how much they could lend to single borrowers. To maintain relationships with key clients and provide additional funding, they used credit derivatives to hedge the excess risk. This allowed them to transfer the credit exposure to third parties while keeping the loans and relationships on their own books for accounting.

27. (A) A contract where the buyer pays a periodic fee for a contingent payment from the seller upon a credit event.
A Credit Default Swap is a standard credit derivative where the protection buyer makes regular premium payments. In exchange, the protection seller agrees to pay a specific amount if the reference entity experiences a credit event, such as bankruptcy. It is essentially a risk-transfer mechanism that functions like insurance against the default of an underlying debt obligation for the buyer.

28. (A) Buying protection is like going short on the bond, gaining if the credit quality of the reference asset decreases.
A protection buyer holds a position that gains value as the creditworthiness of the reference entity deteriorates. Since they receive a payout upon default, their financial interest is inversely related to the credit strength of the borrower. This mirrors a short position in the cash market, where an investor profits from a decline in the price of the security.

29. (A) P-2, Q-3, R-1, S-4
Materiality prevents triggers for minor events, and the payout is typically activated by a credit event. The credit event itself is the occurrence that triggers the contract obligations. The reference asset is the specific underlying debt whose risk is being transferred. Understanding these terms is fundamental to interpreting the legal and financial mechanics of any credit derivative agreement in finance.

30. (D) Protection Seller — Usually hedge funds or insurance companies seeking yield
Protection sellers, such as hedge funds and insurance companies, are motivated by yield enhancement. They assume credit risk in exchange for regular premium income, often seeking to diversify their portfolios. Unlike banks, which typically act as protection buyers to manage their loan books, these entities use credit derivatives to gain synthetic exposure and earn returns on their available capital resources.

31. (C) A credit event is triggered if the default occurred on an obligation satisfying the reference characteristics.
In a Credit Default Swap, the trigger is usually based on the credit status of the reference entity itself, rather than a single specific loan. If the company defaults on any debt that meets the criteria defined in the contract, such as "senior unsecured bonds," a credit event is triggered. This protects the buyer even if their own loan remains performing.

32. (A) Only (I)
A Total Return Swap allows the protection seller to receive the economic benefits of an asset without owning it, which acts as synthetic financing. However, these contracts do not eliminate counterparty risk. In fact, they create significant counterparty risk because both parties depend on each other to fulfill periodic payment obligations based on the asset's performance and market value changes.

33. (B) (I) and (III) only
In physical settlement, the buyer delivers a "deliverable obligation" to the seller. This can be any debt instrument that meets the contract's specifications, not just the original loan. This method is common when sellers have the infrastructure to manage defaulted assets through bankruptcy. The flexibility in choosing

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of both the reference entity and the collateral. If the collateral assets default, the Special Purpose Vehicle will not have enough funds to repay the noteholders' principal, leading to a loss for the investor even if the reference entity remains in good financial standing throughout the note's term.

52. (D) The protection seller will not provide any payout as the CDS contract would have already expired.
A Credit Default Swap only provides protection for the duration specified in the contract. If a bank buys a three-year CDS for a five-year loan, they are only protected against credit events occurring within those first three years. If a default happens in the fourth year, the bank is unhedged as the derivative contract has already reached its maturity date.

53. (B) 40% of the notional value
If a bank buys defaulted bonds at 60% of their notional value and receives 100% from the protection seller, the gain on the transaction is 40%. This gain compensates the bank for the loss in value of its own exposure. This illustrates how physical settlement allows the buyer to realize the full notional value by delivering the distressed asset.

54. (A) P-3, Q-4, R-1, S-2
A credit put option buyer pays a premium for the right to sell an asset. The strike spread is the fixed rate the seller receives upon exercise. In an asset swap package, the option seller must pay the par value to the buyer when exercised. These options are valuable for yield enhancement and managing the costs of future debt issuance.

55. (A) The protection seller assumes the servicing and voting rights of the underlying asset upon entering the swap.
In a Total Return Swap, legal ownership remains with the protection buyer. Consequently, the buyer, not the seller, retains all servicing and voting rights associated with the asset. The seller only receives the economic performance synthetically. This allows the buyer to maintain their relationship and influence with the borrower while transferring the financial risks to the swap counterparty.

56. (A) ABC Bank remains exposed to ₹ 20 million of unhedged credit risk on the loan.
When the notional value of a Credit Default Swap (₹ 100 million) is less than the actual loan amount (₹ 120 million), the bank is only partially protected. The derivative covers only the first ₹ 100 million of the exposure. Any loss related to the remaining ₹ 20 million is still borne by ABC Bank, as it remains unhedged in the contract.

57. (A) Make an upfront payment of par value for the combined package to the corporate treasury.
Exercising a credit put option on an asset swap package requires the seller to purchase the package at the predetermined price. This means the seller must immediately provide the upfront par value to the buyer. In return, the seller takes on the asset and the associated swap, assuming the credit risk and the interest rate exchange according to terms.

58. (A) The buyer delivers a qualifying bond and receives the notional value in cash from the seller.
In a physical settlement, the transaction is completed by the actual transfer of securities. The protection buyer selects a qualifying deliverable obligation of the defaulted entity and transfers it to the seller. Upon receipt of the bonds or loans, the protection seller pays the full notional amount in cash to the buyer, fulfilling the credit protection agreement's specific terms.

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59. (C) The buyer delivers the reference obligation and receives a payment equal to the asset's initial value.
For a Total Return Swap settled via delivery, the protection buyer transfers the reference asset to the seller at the end of the term. The seller then pays the buyer the initial value of the asset. This effectively reverses the synthetic exposure, allowing the buyer to exit the position at the original price, while any changes in value are captured.

60. (B) Interest payments, fees, and change-in-value payments.
The "total return" in a swap encompasses all financial outcomes of owning the asset. This includes periodic income like interest and fees,

creditworthiness of the entity. Since unsecured creditors are paid after secured ones, a default is more likely to be reflected in these instruments first. Hedging against them provides a more sensitive and liquid form of protection for the lender's exposure in the market.

43. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
In a Total Return Swap, the protection buyer maintains legal ownership of the asset, including voting and servicing rights. This is possible because the transfer of economic risk is synthetic and happens via cash flow exchanges rather than a sale. This arrangement ensures confidentiality and allows the bank to hedge risk without notifying the borrower or ending the client relationship.

44. (A) P-3, Q-1, R-2, S-4
Total Return Swaps involve payments based on market valuation changes, while CDS payments occur only upon credit events. Change-in-value payments specifically reflect the asset's price movements. Total return is the aggregate of all economic benefits, including interest, fees, and valuation adjustments. These distinctions define how each derivative handles the cash flow and risk transfer process over the agreement's term.

45. (A) (I), (II), and (III), and (V) only
Credit-Linked Notes are funded balance sheet assets issued by SPVs to provide synthetic exposure. The SPV uses investor funds to buy collateral. However, statement (IV) is incorrect because investors face dual risk—the reference entity and the collateral. These notes effectively bridge the gap between traditional bonds and credit derivatives by embedding the derivative's risk into a funded security.

46. (B) Alpha Bank will deliver the defaulted obligations to the protection seller and receive the par value in cash.
Under physical settlement in a CDS, the protection buyer delivers the defaulted reference obligation to the protection seller. In exchange, the seller pays the buyer the full notional (par) value of the asset. This allows the bank to recover the entire face value of the loan while the seller takes ownership of the distressed debt for potential recovery later.

47. (C) Option Settlement — Exclusively restricted to physical asset delivery.
Like many other derivatives, credit options are flexible in their settlement methods. They are not exclusively restricted to physical delivery. Parties can choose between physical delivery of the reference asset or cash settlement based on the difference between the strike price and the current market value. This choice is usually specified at the time the option contract is written.

48. (B) To create synthetic exposure or profit if the cost of buying protection declines in the future.
Entities sell protection to earn premiums and gain credit exposure without funding. A strategic seller might also profit from market movements; if the perceived risk of the reference entity decreases, the value of the protection they sold increases. This allows them to trade credit views synthetically and efficiently within the market without owning the physical bond or loan.

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49. (B) Fund Y pays Bank X ₹ 70,000.
In this TRS, Bank X owes Fund Y the interest and fees of ₹ 50,000. However, because the asset depreciated, the TR receiver owes Bank X the amount of the depreciation of ₹ 120,000. Netting these amounts results in Fund Y paying Bank X ₹ 70,000 to cover the market loss beyond the earned income for that settlement period.

50. (C) Legal costs of bankruptcy filing
The 'total return' transferred in a TRS consists of the direct economic benefits and value changes of the asset, such as interest, fees, and market appreciation or depreciation. Ancillary costs like legal fees for bankruptcy are generally not included in the swap's calculation of total return, as they are operational expenses rather than components of the asset's financial performance.

51. (C) If the underlying collateral assets default, the investor is shielded from loss as long as the reference entity performs well.
This statement is incorrect because Credit-Linked Note investors assume the credit risk

ANSWERS

1. (D) An entity that seeks protection against the risk of default of the reference obligation.
A protection buyer enters a credit derivative transaction to transfer the credit risk of a specific reference entity to another party. This entity typically owns the underlying debt and wants to hedge against potential losses arising from default or credit deterioration. By paying a periodic fee, they secure a contingent payment if a credit event occurs, thereby mitigating their exposure.

2. (C) The asset remains on the seller's balance sheet earning continuous interest income.
In a credit derivative, the underlying asset typically remains on the protection buyer's balance sheet, not the seller's. The seller gains exposure synthetically without owning the physical asset. Therefore, earning direct interest from the physical asset is a benefit for the buyer, while the seller earns premium income for assuming the risk off-balance sheet without any initial funding requirement.

3. (C) A contract shifting credit risk between parties, with value derived from the credit performance of a reference entity.
Credit derivatives are financial instruments designed to isolate and transfer the credit risk associated with an underlying asset without transferring the asset itself. The value of these contracts is tied to the creditworthiness of a third-party reference entity. They allow institutions to manage credit exposure independently from funding, providing a flexible method for risk sharing within the global financial markets.

4. (C) Transferring credit risk is strictly prohibited for pools of assets and only possible for large individual exposures.
Credit derivatives offer significant flexibility and are not restricted to single large exposures. They can be effectively structured to cover diverse portfolios or pools of assets, such as small and medium enterprise loans or auto leases. This versatility allows financial institutions to manage risk across entire industry sectors or specific credit quality tiers efficiently using specialized derivative structures and agreements.

5. (B) To achieve yield enhancement or gains from synthetic exposures where creating a direct loan portfolio is not feasible.
Protection sellers are primarily driven by the opportunity to generate additional income through premiums without an upfront cash outlay. This allows them to create synthetic credit exposure to entities they might otherwise be unable to lend to directly. It is a strategic method for yield enhancement and diversifying their risk portfolio through non-funded credit instruments in the over-the-counter market.

6. (B) Notional Value — The reference value for computing the premium and protection contingency payment.
The notional value is a critical component of a Credit Default Swap, serving as the benchmark amount for all financial calculations. It represents the face value of the credit protection and is used to determine both the periodic premium payments and the potential contingent payout. It does not necessarily represent an actual exchange of principal at the inception of the derivative.

7. (A) II, III, I
Financial innovation typically begins with an established, traditional financial contract that contains various embedded risks. The next stage involves unbundling or isolating these specific risk components, such as credit risk, from the original instrument. Finally, these isolated components are repackaged into a new, specialized contract like a credit derivative to meet specific risk management needs and market demands.

8. (A) P-1, Q-3, R-2, S-4
Risk transfer enables buyers to underwrite more credit, while asset retention keeps loans on their balance sheet. For sellers, income generation involves earning premiums for

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as well as capital gains or losses reflected in change-in-value payments. By transferring these components, the protection buyer effectively places the TR seller in the same economic position as if they had directly owned the reference asset.

61. (B) P-2, Q-3, R-1, S-4
The protection seller is the party assuming the credit risk. A credit event is a negative change in a borrower's creditworthiness. Credit-linked notes are funded assets that offer synthetic exposure through a bond-like structure. Finally, the payout is the financial compensation triggered by a credit event. These definitions form the basic vocabulary for understanding the roles of credit derivatives.

62. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Credit-Linked Notes must offer higher yields than traditional bonds to attract investors. This premium is necessary because noteholders are not just betting on the reference entity's survival but are also exposed to the risk of the collateral assets failing. This dual risk structure increases the overall probability of loss, justifying the higher compensatory returns provided to the investor in notes.

63. (C) ₹ 6 million
When a credit event occurs, the SPV liquidates its collateral for ₹ 10 million. From these proceeds, it must first satisfy its obligation to the credit swap counterparty through a ₹ 4 million contingent payment. The remaining funds of ₹ 6 million are then distributed to the CLN investors, representing their recovery on the principal investment after the default event.

64. (B) (I) and (III) only
Credit derivatives are powerful because they de-couple credit risk from funding. They allow institutions to adjust their risk exposure without the need to physically buy or sell the underlying bonds or loans in the secondary market. This provides flexibility and confidentiality. Statement (II) is incorrect because the primary advantage is that they do not require selling the bonds.

65. (I), (II), and (III) only
The primary participants in the credit derivatives market are large institutional players. These include banks, security houses, insurance companies, hedge funds, and pension funds. These entities use these instruments for hedging, yield enhancement, and portfolio management. Individual retail borrowers, such as those in microfinance, are not typical users of these complex, over-the-counter financial instruments in the global market.

66. (D) The investor suffers a loss based on the collateral's recovery, despite Company A's performance.
Because a Credit-Linked Note investor is exposed to the credit risk of the underlying collateral, a default by the collateral directly impacts them. Even if the reference entity remains performing, the loss of collateral value means the SPV cannot repay the full principal. This demonstrates the "dual risk" nature inherent in the structure of these funded credit notes.

67. (C) Credit Event — An event that strictly guarantees the improvement of a borrower's creditworthiness.
This pairing is incorrect because a credit event is defined as an occurrence that signals a deterioration or negative change in a borrower's financial health, such as bankruptcy or failure to pay debt. The purpose of defining these events in a credit derivative contract is to trigger a payout to the protection buyer due to the increased risk.

68. (D) (I), (II), (III), (IV), and (V)
The credit derivatives market includes a wide array of specialized products beyond basic swaps. These include basket products for multiple entities, equity-linked credit instruments, synthetic Collateralized Debt Obligations, swaptions for option-based exposure, and tranched index trades. This variety allows market participants to tailor their credit risk management and investment strategies to very specific needs and risk profiles in finance.

69. (A) II, III, I
The process of physical settlement begins with the occurrence of a credit event that

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(D) (I), (II), and (III)

May/June 2023

40. Which of the following statements accurately describes the reporting line of the Middle Office?

(A) The Middle Office must report directly to the Front Office to facilitate rapid trading decisions.

(B) The Middle Office reports exclusively to the Back Office to assist in payment systems reconciliation.

(C) The Middle Office is an ad-hoc function that reports only to external rating agencies.

(D) The Middle Office reports to ALCO independently of treasury to maintain segregation of duties.

Oct/Nov 2009

41. Which of the following describes the objective of scenario analysis and stress testing?

(A) To ensure that the historical data perfectly predicts the future without the need for forward-looking scenarios.

(B) To assess the effects of market risk changes on holdings, including low probability adverse scenarios.

(C) To determine the specific day an individual counterparty will default.

(D) To replace all daily mark-to-market valuation requirements with qualitative assessments.

May/June 2016

42. Match the organizational units in List I with their primary responsibilities for managing market risk in List II.

List I: (Organizational Unit)

P. Board of Directors

Q. Risk Management Committee

R. Asset-Liability Management Committee (ALCO)

S. ALM Support Group

List II: (Primary Responsibility)

1. Responsible for balance sheet planning from a risk-return perspective and deciding business strategy
2. Consists of operating staff responsible for analysing, monitoring and reporting risk profiles via simulations
3. Has overall responsibility for management of risks, decides policies, and sets limits
4. Mandates market risk management practices along with the Board (often sets discretionary limits for Dealing Room)

(A) P-3, Q-4, R-1, S-2

(B) P-1, Q-2, R-3, S-4

(C) P-3, Q-1, R-4, S-2

(D) P-4, Q-3, R-2, S-1

Oct/Nov 2018

43. Read the following statements concerning factors to consider when setting a market risk strategy:

I Economic, market, and liquidity conditions and their impact on market risk.

II Whether the institution has the expertise to take positions in specific markets.

III The ability to identify, measure, evaluate, monitor, report, and control/mitigate risk on a timely basis.

IV The institution's portfolio mix and how it would be affected if more market risk was assumed.

V The political affiliation of the counterparties in foreign exchange transactions.

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (IV)

(B) (I), (II), (IV), and (V)

(C) (II), (III), (IV), and (V)

(D) (I), (III), (IV), and (V)

May/June 2007

44. During an internal audit, it is discovered that dealers in the Front Office are providing the end-of-day market rates to the Back Office for the revaluation of the trading portfolio. To rectify this and align with standard risk controls, how must market rates be sourced?

(A) They must be derived exclusively from the internal models created by the dealers themselves.

(B) They must be sourced from the ALM Support Group on a monthly basis for historical tracking.

(C) They must be calculated based on the historical average of the previous financial year.

(D) They must be sourced independently of the Dealing Room by the Back or Middle Office.

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CHAPTER 13
Market Risk

Oct/Nov 2018

1. The major components of market risk include all of the following, EXCEPT:
(A) Liquidity risk
(B) Settlement risk
(C) Basis risk
(D) Operational risk

May/June 2007

2. A bank's treasury holds a two-month forward long position in US$, which it hedges using a three-month short position in US$. Over the next month, the difference between the two-month forward exchange rate and the three-month forward exchange rate moves adversely. What specific type of risk has materialized?
(A) Settlement risk, occurring when a counterparty fails to deliver the promised US$ at the maturity date.
(B) Basis risk, occurring when interest rates on domestic bonds change independently of the foreign hedge.
(C) Gap risk, caused by non-parallel movement of exchange rates across different time horizons.
(D) Sovereign risk, occurring when a foreign government changes its monetary policy unexpectedly.

Oct/Nov 2025

3. Why is the period of liquidation considered critical when assessing market risk for traded instruments?
(A) Shorter liquidation periods inherently amplify the price deviations of assets.
(B) Regulatory authorities require all liquidations to occur within a fixed single-day horizon.
(C) As holding periods get longer, so do the deviations from the current market value.
(D) Liquidation periods dictate the coupon rate payments of fixed income securities.

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May/June 2012

4. Which of the following clearly distinguishes 'Asset liquidation risk' from 'Market liquidation risk'?
(A) Asset liquidation risk occurs when a general liquidity crunch hits the entire market, whereas Market liquidation risk applies only to government bonds.
(B) Asset liquidation risk relates to physical assets like real estate, whereas Market liquidation risk deals with equities.
(C) Asset liquidation risk concerns a specific asset's liquidity, while Market liquidation risk involves a market-wide crunch.
(D) There is no distinction; both terms refer to the inability of a bank to meet its short-term deposit withdrawal demands.

Oct/Nov 2014

5. An investment bank holds a large portfolio of mortgage-backed securities (MBS). The market experiences a sudden, sharp decline in mortgage interest rates. The portfolio manager notices a significant alteration in the cash flow pattern of the MBS. What is the most likely risk materializing in this scenario?
(A) Extension risk, causing prepayments to slow down and ultimately benefiting the long-term investors.
(B) Contraction risk, causing prepayments and forcing the reinvestment of funds at lower market rates.
(C) Call risk, leading the primary issuer to extend the maturity of the underlying bonds indefinitely.
(D) Basis risk, resulting in a perfect parallel shift of the yield curve enhancing total portfolio value.

May/June 2019

6. Bank X enters into a currency swap with Bank Y. The mark-to-market value of the swap is highly positive for Bank X. Suddenly, Bank Y

triggers the contract. Following the event, the protection buyer must fulfill their part by physically delivering the deliverable obligations to the protection seller. Finally, once the seller receives the assets, they pay the buyer the agreed par value, completing the compensatory exchange for the protection provided.

70. (B) The risk assessment capability of the protection seller prepared to take the risk.
Credit derivatives function on the basis of risk transfer. For this to work, there must be a counterparty who is willing and able to assess and assume the credit risk of the reference entity. Without a party capable of pricing and managing the risk in exchange for a premium, the market for transferring credit exposure could not exist functionally.

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May/June 2018

12. Match the portfolio categories in List I with their characteristic features in List II.

List I: (Portfolio Category)

P. Held to Maturity (HTM)

Q. Trading Book

R. Banking Book

S. Marked to Market

List II: (Characteristic Feature)

1. Repricing of a bank's portfolio to reflect changes in asset prices
2. Constituted by Available for Sale (AFS) and Held for Trading (HFT) categories
3. Provides a cushion for banks from valuation changes and is not marked to market
4. Underlying principle is "Buy and Hold"

(A) P-3, Q-2, R-4, S-1

(B) P-2, Q-3, R-1, S-4

(C) P-4, Q-1, R-3, S-2

(D) P-3, Q-4, R-2, S-1

Oct/Nov 2016

13. Read the following statements regarding Foreign Exchange Risk:

I Favorable movements in exchange rates give rise to profits, but banks are more concerned about downside risks.

II Like interest rates, exchange rates are time-dependent, meaning spot rates differ from forward rates.

III Gap risk arises due to parallel movements across the spectrum of exchange rates.

IV Gap risk depends on the movement of spot exchange rates and the interest rate differential of the two countries.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III)

(B) (I), (II), and (IV)

(C) (II), (III), and (IV)

(D) (I), (III), and (IV)

May/June 2014

14. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct answer using the options given below.

Assertion (A): Determining the magnitude of interest rate changes across different maturities requires assuming that the yield curve always remains flat and shifts in parallel.

Reason (R): The yield curve changes with time and parallel shifts across all maturities rarely happen, giving rise to yield curve risk.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2007

15. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct answer using the options given below.

Assertion (A): Under a 'hold to maturity' view for derivatives, the potential future value over their life is considered the credit risk exposure.

Reason (R): The potential future value represents all future flows that the defaulted counterparty will not pay.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

May/June 2025

16. How is market risk defined in the context of banking activities?

(A) Potential losses in on-and-off balance-sheet positions due to adverse market price movements

(B) Risk of widespread borrower defaults on loan repayments which leads to a rise in non-performing assets

(C) Risk arising from inadequate systemic liquidity levels that may potentially trigger sudden bank runs

(D) Risk associated with the failure of internal operational processes, systems, or various human errors

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experiences a severe credit downgrade. What specific risk does Bank X face?

(A) Asset liquidation risk, which is dictated solely by the original nominal value of the currency swap.
(B) Credit and counterparty risk, where exposure is the liquidation value of the future cash flows.
(C) Extension risk, which is dictated by Bank Y's inability to prepay the swap before its maturity.
(D) Specific equity risk, dictated by the fall in Bank Y's stock price following the downgrade event.

Oct/Nov 2006

7. What is one of the key reasons for the growing importance of risk management in banks since the 1990s?

(A) A significant shift from traditional wholesale banking toward higher-volume retail banking transactions
(B) Rapid expansion in trading activity and the diversity of financial instruments traded
(C) The complete elimination of foreign exchange volatility through the adoption of fixed rate regimes
(D) A marked decrease in global computing power which necessitated return to manual risk tracking

May/June 2021

8. A fund manager constructs a highly diversified equity portfolio containing stocks from 50 different sectors. One of the companies in the portfolio suddenly announces a massive fall in production due to a factory fire, causing its stock price to plummet. Despite this, the overall value of the diversified portfolio remains relatively stable. Which of the following best explains this outcome?

(A) The general market risk of the affected stock was perfectly hedged by forward contracts.
(B) In a well-diversified portfolio, the specific or idiosyncratic risk stands eliminated very substantially.
(C) The portfolio's beta factor automatically adjusted to zero during the event.
(D) Stock prices are not volatile when held in a trading book for long-term investment.

Oct/Nov 2010

9. A financial institution is setting up a desk to manage a commodity book. The risk manager notes that forward prices for different maturities of the same commodity are shifting unevenly. Furthermore, the desk trades in base metals and often faces challenges in closing out positions before the physical delivery date. Which risks are primarily highlighted?

(A) Idiosyncratic risk and counterparty settlement risk during the physical exchange of documents.
(B) Gap risk and the operational necessity to close out positions prior to the physical delivery date.
(C) Call risk and reinvestment risk related to the long-term yields of the commodity-backed securities.
(D) General market risk and macroeconomic systemic risk arising from global supply chain disruptions.

May/June 2005

10. For an investor holding a fixed income security, what is the most significant consequence of an increase in interest rates if the security must be sold before its maturity date?

(A) An increase in the coupon payments received before the sale
(B) An automatic extension of the maturity date
(C) The realization of a capital loss
(D) An immediate downgrade in the credit rating of the issuer

Oct/Nov 2022

11. To obviate settlement risk in India, monetary authorities have directed that inter-bank transaction settlements process through which entity?

(A) The Board of Directors
(B) The Asset-Liability Management Committee (ALCO)
(C) The Foreign Exchange Dealers' Association of India (FEDAI)
(D) The Central Counterparty (CCP) via the Clearing Corporation of India

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(B) Assets under the HTM category are required to be marked to market on a daily basis.
(C) Trading book transactions are often termed as wholesale transactions, making them highly sensitive to market swings.
(D) Marking to market enables the portfolio to reflect asset price changes resulting from market price movements.

Oct/Nov 2005

23. Which of the following pairs is correctly matched regarding the risks in fixed income securities?
(A) Call risk — The risk that homeowners will prepay their mortgage when interest rates rise.
(B) Contraction risk — The risk that mortgage prepayments will slow down when interest rates rise.
(C) Basis risk — The risk arising from a perfect parallel shift in the yield curve across all maturities.
(D) Reinvestment risk — Variability in returns from reinvesting cash flows due to market rate changes.

May/June 2020

24. How does 'pure' market risk differ from market liquidity risk?
(A) Pure market risk relates exclusively to physical commodities, whereas liquidity risk only applies to derivatives.
(B) Pure market risk vanishes completely when liquidity is high, making market liquidity risk the sole concern.
(C) Market liquidity risk measures the volatility of foreign exchange, whereas pure market risk measures interest rate differentials.
(D) Pure market risk stems from changes in market parameters, while liquidity risk involves price deviations due to thin trading.

Oct/Nov 2015

25. In a foreign exchange portfolio, the exchange rate risk mainly depends upon the movement of which of the following?
(A) The one-month forward exchange rate exclusively
(B) The spot exchange rate of two currencies
(C) The historical average of the exchange rate over the previous decade
(D) The consumer price index differential of the two countries

May/June 2013

26. Which of the following statements correctly differentiates the trading book from the banking book?
(A) The trading book holds assets till maturity, whereas the banking book holds assets for short-term profit.
(B) Exposures in the trading book are generally smaller in transaction size compared to the retail transactions in the banking book.
(C) The underlying principle for the banking book is "Buy and Sell", while for the trading book it is "Buy and Hold".
(D) Assets in the trading book are held for a relatively shorter period and are marked to market, unlike the banking book.

Oct/Nov 2021

27. Which of the following statements is correct regarding the credit risk of traded debts?
(A) Lowering a credit rating increases the spread over the risk-free rate, leading to a decline in price.
(B) A higher risk level assigned by rating agencies results in a lower spread over the risk-free rate.
(C) Credit rating indicates the risk level associated with the instrument and is deducted from the risk-free rate of the corresponding maturity.
(D) Default by an issuer has no adverse impact on the market price of the financial instrument if it is held to maturity.

May/June 2024

28. Read the following statements regarding price risk and reinvestment risk:
I Price risk and reinvestment risk oppose each other in their reaction to interest rate changes.
II A strategy based on offsetting price risk and reinvestment risk is known as immunization.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)

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(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2008

29. Identify the incorrect statement regarding the regulatory environment and operational aspects of commodity risk for banks.
(A) Managing a commodity book entails monitoring directional risk, basis risk, and various forms of gap risk.
(B) Commodity markets carry higher risk due to high price volatility and the potential for price discontinuities.
(C) Regulators typically prohibit banks from taking direct exposures in physical commodity or derivative markets.
(D) Banks may finance entities like the Food Corporation of India under specific credit programs as per directives.

May/June 2006

30. Read the following statements concerning Basis Risk:
I It develops because of a non-parallel adverse movement of the price of an instrument and that of its hedge.
II It represents the gap between the discounted cash flows of the portfolio and that of the hedging instrument.
III It is entirely eliminated when a perfect parallel shift in the yield curve occurs.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2017

31. The role of the Asset-Liability Management Committee (ALCO) includes all of the following, EXCEPT:
(A) Deciding on the desired maturity profile and mix of incremental assets and liabilities
(B) Reviewing and articulating the funding policy
(C) Executing daily buy, sell, and hedging operations to book trading profits
(D) Reviewing the economic and political impact on the balance sheet

May/June 2008

32. Read the following statements regarding capital allocation:
I Institutions are encouraged to have an internal capital allocation system that meaningfully links identification, monitoring, and evaluation of market risks to economic capital.
II Significant changes in the size or scope of activities should trigger an analysis of the adequacy of capital supporting the activities.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2013

33. A quantitative analyst at a bank designs a complex Value at Risk (VaR) model to predict market risk. The model is immediately deployed into the live trading environment by the same analyst without any secondary review. According to model risk management principles, what critical control failure occurred?
(A) The model was not subjected to a random walk simulation for checking data integrity.
(B) Validation and testing were not performed by personnel independent of the model's design.
(C) The analyst failed to use historical data spanning at least a century for the model.
(D) The model ignored the specific idiosyncratic risk associated with government bonds.

NODIA

May/June 2015

34. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct answer using the options given below.
Assertion (A): Due to correlated risks, an institution's aggregate overall risk could significantly increase and exceed its risk tolerance, even if individual market and credit risks appear manageable.
Reason (R): Correlations between markets could result in the transmission of shocks from stressed conditions in one market to other markets.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2012

35. Arrange the logical sequence of steps an institution should follow in setting up its market risk strategy:
1. Develop a strategy that balances business goals with the determined market risk appetite.
2. The Board determines the level of market risk the institution is prepared to assume (risk appetite).
3. Evaluate the effectiveness of hedging strategies and assumptions.
4. Put in place a process by which significant changes in activities trigger an analysis of capital adequacy.

(A) 2, 1, 3, 4
(B) 1, 2, 4, 3
(C) 2, 3, 1, 4
(D) 4, 2, 1, 3

May/June 2011

36. Read the following statements regarding the establishment of Market Risk Limits:
I Limits should preferably be integrated, where applicable, with group-wide limits for each major type of risk assumed.
II The institution should set limits that are sufficiently granular for effective risk control.
III Limits for trading desks, portfolios, and dealers by markets, products, instruments, and tenors should be set where appropriate.
IV Compliance with limits should be monitored by the very same business unit taking the risks, to streamline operations.

Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

Oct/Nov 2020

37. How is 'Model Risk' defined in the context of risk management?
(A) The gap between the value predicted through a model and the value actually observed.
(B) The risk that a pricing model will perfectly forecast market prices, leading to excessive trading volumes.
(C) The risk that regulatory authorities will reject the internal capital adequacy models.
(D) The statistical certainty that all observed data fits a normal distribution.

May/June 2022

38. A bank relies on a hedging strategy that assumes a strict historical correlation between the price of oil and a specific energy stock. A sudden geopolitical event disrupts this correlation, causing both to lose value. What should the institution do?
(A) Hedged instruments cannot be exposed to market risks once hedged; assume operational failure.
(B) The Board should transfer energy exposures to the Banking Book to avoid recognizing losses.
(C) The institution should increase the transaction size to force the correlation back to average.
(D) The institution must assess the effectiveness of strategies if correlation assumptions break down.

Oct/Nov 2023

39. Read the following statements regarding a sound risk management framework:
I A framework to identify risks.
II An appropriately detailed structure of market risk limits consistent with the institution's risk appetite.
III Exception tracking and reporting processes that ensure prompt action at the Board or appropriate level of senior management.

Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only

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Oct/Nov 2019

17. Liquidation risk arises from the lack of trading liquidity and results in all of the following, EXCEPT:

(A) Assured elimination of settlement risk for all high-volume inter-bank currency transactions

(B) Adverse changes in market prices due to the inability to find matching buyers or sellers

(C) Inability to liquidate a financial position at what is considered the fair market price

(D) Liquidation of a position causing a large price change that impacts the overall portfolio

May/June 2009

18. A commercial bank recently acquired a large volume of fixed income securities. The treasury department intends to capitalize on short-term interest rate fluctuations by actively buying and selling these bonds over the next month. Meanwhile, the retail division continues to issue standard 15-year home loans. Based on portfolio classification principles, how should these exposures be treated for risk management?

(A) The bonds should be placed in the trading book subject to daily mark-to-market valuation, while the home loans remain in the banking book.

(B) Both the bonds and the home loans must be classified under the Held to Maturity (HTM) category to stabilize earnings.

(C) The bonds should be allocated to the banking book since fixed income securities cannot be subjected to wholesale market swings.

(D) Both portfolios should be marked to market daily as they are equally sensitive to short-term market fluctuations.

Oct/Nov 2011

19. Read the following statements regarding the characteristics of commodity markets:

I Commodity prices are strongly dependent on demand and supply dynamics.

II Market liquidity or depth of trading market varies frequently, adding to price volatility.

III Transaction costs are uniform across all commodities and geographies.

IV Commodities may be perishable, having a short life (e.g., agro or energy commodities).

V Commodities may have widely differing price-to-weight ratios (e.g., gold vs base metals).

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (V)

(B) (I), (II), (IV), and (V)

(C) (II), (III), (IV), and (V)

(D) (I), (III), (IV), and (V)

May/June 2010

20. How is the 'specific or idiosyncratic risk' of equity defined?

(A) Price movements due to firm-specific factors like management changes or market share shifts.

(B) The sensitivity of a specific stock's price movements relative to broad market indices like Nifty.

(C) General price volatility resulting from changes in macroeconomic fundamentals or national policies.

(D) The systemic risk that an entire equity portfolio will decline due to a broad national liquidity crisis.

Oct/Nov 2024

21. Read the following statements regarding settlement risk:

I Settlement risk occurs when one party defaults in completing the settlement after the other party has fulfilled its obligation.

II In India, the Reserve Bank of India implemented the Real Time Gross Settlement System to enhance settlement risk, making transactions highly volatile.

Which of the above statement(s) is/are correct?

(A) Only (I)

(B) Only (II)

(C) Both (I) and (II)

(D) Neither (I) nor (II)

NODIA

May/June 2017

22. Identify the incorrect statement regarding the valuation and categorization of bank investment portfolios.

(A) Securities held under the AFS and HFT categories form the trading book of banks.

Oct/Nov 2025

45. Identify the incorrect statement concerning the evaluation of market risk measurement models.
(A) The models should provide reasonable estimates of market risk.
(B) A back-testing programme should be conducted regularly to verify that models are reliable in measuring potential losses.
(C) Back-testing is prohibited when there are significant and unprecedented market developments.
(D) The Board and senior management should be cognizant of the strengths and material limitations of the institution's market risk measurement systems.

May/June 2012

46. Which of the following is NOT a valid reason giving rise to model risk?
(A) Incorrect assumptions — Using assumptions which have become non-relevant.
(B) Perfect alignment — Utilizing theoretical outcomes that match all exhaustive data points flawlessly.
(C) Ignoring parameters — Simplifying models by dropping one or more parameters for practical reasons.
(D) Dealing with outliers — Making incorrect judgments when handling anomalous data points.

Oct/Nov 2014

47. Why must an institution monitor its risk profile on an intra-day basis if its risk levels fluctuate significantly?
(A) To comply with the weekly reporting requirements of the central bank.
(B) To identify risks promptly and allow remedial action against sudden adverse market changes.
(C) To ensure that the daily coupon payments on government bonds are credited in real-time.
(D) Intra-day monitoring eliminates the need to hold capital against unexpected losses.

May/June 2019

48. A bank's ALCO is evaluating its current risk appetite and compliance with risk policies. To ensure unbiased reporting, the ALCO requires an independent risk assessment of the trading activities. Which organizational unit must be tasked with providing this independent monitoring, measurement, and analysis, effectively acting as the ALCO's secretariat?
(A) The Dealing Room (Front Office)
(B) The Middle Office
(C) The Back Office settlement team
(D) The Board of Directors

Oct/Nov 2006

49. Which of the following pairs correctly matches a policy requirement with its description?
(A) Communication — Prescribing how market risk is measured and communicated to the Board.
(B) Scope of activities — Delineating lines of authority and responsibilities of the senior management.
(C) Capital against losses — Setting guidelines for the delegation of authority for limit excesses.
(D) Disputed transactions — Formulating policies via external auditors without specific Board approval.

May/June 2021

50. Match the structural unit in List I with its core function in List II.
List I: (Structural Unit)
P. Front Office
Q. Middle Office
R. Back Office
S. Risk Management Committee
List II: (Core Function)
1. Controls over confirmations, nostros/vostros reconciliation, and payment systems
2. Handles deals and buy/sell/hedging operations to book trading profits
3. Establishes risk limits and provides authorities for the Dealing Room
4. Prepares forecasts (simulations) showing effects of changes in market conditions, independent of treasury
(A) P-2, Q-4, R-1, S-3
(B) P-4, Q-2, R-3, S-1
(C) P-2, Q-1, R-4, S-3
(D) P-1, Q-3, R-2, S-4

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Oct/Nov 2010

51. Arrange the procedural actions required when a unit independent of risk-taking activities identifies limit excesses:

1. Seek approval from the Board or senior management for temporary excesses and limit increases.
2. Investigate the reasons for the limit excesses.
3. Report the incidents to management.

(A) 2, 3, 1
(B) 1, 2, 3
(C) 3, 2, 1
(D) 2, 1, 3

May/June 2005

52. Read the following statements regarding the role of the Asset-Liability Management Committee (ALCO):

I Product pricing for deposits and advances
II Articulating interest rate view of the bank and deciding on the future business strategy
III Preparing back-testing programs for complex VaR models independently of the treasury

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2022

53. Read the following statements regarding the critical controls of the Back Office:

I Issuing and receiving all confirmations for transactions concluded by the Dealing Room.
II Prompt reconciliation of all dealing accounts (vostros and nostros).
III Structuring the macro-economic business strategy of the bank.
IV Revaluations and marking-to-market of market risk exposures using independently sourced market rates.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

NODIA

May/June 2018

54. An institution's risk measurement monitoring and control framework should include all of the following, EXCEPT:

(A) Guidelines and other parameters used to govern market risk-taking
(B) Processes for the allocation of positions to the trading book
(C) Elimination of management information systems (MIS) to ensure data confidentiality
(D) Valuation policies for making appropriate adjustments for uncertainties in determining fair value of assets

Oct/Nov 2016

55. When setting a market risk strategy, what is the most important factor to establish first?

(A) The risk appetite, setting limits for management against unexpected losses
(B) The exact mathematical formula utilized for the internal VaR model
(C) The hiring policy for Front Office dealers and senior treasury staff
(D) The specific software vendor for the Back Office payment and settlement system

May/June 2014

56. A robust market risk management framework should ensure that risk processes and capital levels are adequate for countering the impact of potential stress developments. Which of the following best represents an environment condition that such a framework must account for?

(A) Deterioration of market liquidity conditions emanating from the operating environment
(B) The guarantee of constant and unchanging market parameters over a long-term horizon
(C) The complete elimination of all credit risk from the banking book via regulatory shifts
(D) The assumption that the general market and macroeconomic conditions remain stable

Oct/Nov 2007

57. A bank's internal VaR model relies on five-year-old data. Following a structural shift in the market, management orders back-testing. What should this validation verify?

(A) Data consistency and the appropriateness of volatility and correlation assumptions.
(B) That the model is adjusted to report zero potential losses over time to stakeholders.
(C) That the data sources are restricted to the post-shift period, deleting historical data.
(D) That validation is carried out by the same personnel who built the model for continuity.

May/June 2025

58. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct answer using the options given below.
Assertion (A): Critical to a Dealing Room's effective functioning is all dealers' access to a comprehensive Dealing Room manual covering all aspects of their day-to-day activities.
Reason (R): The manual must cover the bank's requirements in respect of the Code of Conduct prescribed by relevant industry bodies such as FEDAI or FIMMDA.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2019

59. A junior trader executes trades that exceed the market risk control limits and claims ignorance of the operational steps. How should this be prevented according to standard procedures?
(A) Procedures must be stored securely off-site and accessed only during the annual audit process.
(B) The Board of Directors must verbally communicate the limits to each trader on a daily basis.
(C) Documented procedures should spell out operational steps, and staff must be familiar with them.
(D) Limits should only be enforced for the Banking Book, exempting all derivative trading desks.

May/June 2009

60. Identify the incorrect statement regarding the Back Office's control over payment systems.
(A) Procedures and systems for making payments must be under at least dual control in the Back Office.
(B) Dealers may override Back Office payment controls during periods of high-volatility trading.
(C) The payment function must remain strictly independent from the dealing and trading function.
(D) Payment systems should be secured from access or tampering by unauthorized banking personnel.

Oct/Nov 2011

61. Which of the following pairs concerning the intention behind portfolio categories is incorrectly matched?
(A) HTM category — Buy and Hold
(B) Trading Book — Buy and Sell
(C) Available for Sale (AFS) — Intention is strictly to hold till maturity
(D) Held for Trading (HFT) — Intention is to trade by taking advantage of short-term price movements

May/June 2010

62. Match the terms in List I with their corresponding definitions in List II.
List I: (Term)
P. Banking Book
Q. Trading Book
R. Mark-to-Market
S. Trading liquidity
List II: (Definition)
1. Ability to liquidate positions without affecting market prices or attracting attention of other participants
2. Investments held for generating profits on the short-term differences in prices/yields
3. Assets and liabilities contracted basically on account of relationship or for steady income and held till maturity
4. Accounting for the fair value of an asset or liability based on the current market price
(A) P-3, Q-2, R-4, S-1
(B) P-2, Q-3, R-1, S-4
(C) P-4, Q-1, R-3, S-2
(D) P-3, Q-4, R-2, S-1

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independence ensures that errors, biases, or flawed assumptions in the model are identified.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Aggregate risk can exceed an institution's tolerance even if individual risks seem manageable because different risks are often correlated. During market stress, shocks in one sector can transmit to others, causing losses to mount simultaneously across various portfolios. Understanding these interconnections is essential for accurate risk measurement, as assuming independence between different types of market risks can lead to significant underestimation.

35. (A) 2, 1, 3, 4
Setting up a market risk strategy begins with the Board determining the risk appetite. Next, a strategy is developed to balance business goals with this appetite. The institution must then evaluate the effectiveness of its hedging strategies and underlying assumptions. Finally, a process is established to trigger capital adequacy analysis whenever there are significant changes in the institution's financial activities or scope.

36. (A) (I), (II), and (III)
Market risk limits should be integrated with group-wide risk targets and granular enough to provide effective control over trading desks and specific instruments. While setting these limits is essential, monitoring compliance must be conducted by a unit independent of the risk-taking business unit. Self-monitoring by the business unit taking the risks would violate the necessary segregation of duties for effective management.

37. (A) The gap between the value predicted through a model and the value actually observed.
Model risk is defined as the potential for loss resulting from the gap between the value predicted by a quantitative model and the actual market value observed. This risk arises from incorrect assumptions, simplified parameters, or flawed data. Because banks rely heavily on models for pricing and risk measurement, identifying these discrepancies is critical to ensuring the institution's overall financial stability.

38. (D) The institution must assess the effectiveness of strategies if correlation assumptions break down.
When the historical correlation between a hedged asset and its hedging instrument breaks down due to unexpected events, the institution must re-evaluate the effectiveness of its strategy. Since the hedge is no longer providing the intended protection, the bank must determine if the assumptions underlying the risk mitigation are still valid and adjust its positions or models to reflect the reality.

39. (D) (I), (II), and (III)
A sound risk management framework must include a system to identify all relevant risks and a detailed structure of limits aligned with the institution's risk appetite. Furthermore, robust exception tracking and reporting processes are required to ensure that any breaches are promptly addressed by senior management. These elements combined provide the necessary oversight to keep market risk within acceptable and manageable levels.

40. (D) The Middle Office reports to ALCO independently of treasury to maintain segregation of duties.
To maintain an effective segregation of duties, the Middle Office must report to the Asset-Liability Management Committee independently of the treasury's Front Office. This independence allows the Middle Office to provide unbiased monitoring, measurement, and analysis of risks. By not reporting to the traders they are monitoring, the Middle Office ensures that risk reporting remains objective, transparent, and unbiased.

41. (B) To assess the effects of market risk changes on holdings, including low probability adverse scenarios.
Scenario analysis and stress testing aim to evaluate how adverse market changes could affect an institution's holdings. This process involves examining low-probability but high-impact events that might not be captured by standard risk models using historical data. By

NODIA

1. Potential loss to the earnings and capital position caused by changes in market variables
2. Securities acquired with the intention to hold them up to maturity
3. Securities where the intention is neither to trade nor to hold till maturity
4. Securities where the intention is to trade by taking advantage of short-term price movements

(A) P-2, Q-4, R-3, S-1
(B) P-4, Q-3, R-1, S-2
(C) P-2, Q-1, R-4, S-3
(D) P-3, Q-4, R-2, S-1

May/June 2024

70. Why does market risk require more attention and a comprehensive risk management structure in a bank?

(A) Because it is the only risk that affects retail loans in the banking book.
(B) Because it is the most volatile and fluid risk that changes very quickly.
(C) Because it cannot be measured using quantitative models like Value at Risk.
(D) Because the Board of Directors delegates its entire management directly to the Front Office dealers.

NODIA

ANSWERS

1. (D) Operational risk
Market risk involves potential losses from changes in market prices like interest rates, currency rates, equity prices, and commodity prices. It includes liquidity risk, settlement risk, and basis risk. Operational risk is distinct, arising from internal process failures, human errors, or system issues rather than market fluctuations, thus it is not categorized as a major component of market risk.

2. (C) Gap risk, caused by non-parallel movement of exchange rates across different time horizons.
Gap risk materializes when there is a non-parallel movement of exchange rates across different time horizons or maturities. In this scenario, the adverse change in the difference between the two-month and three-month forward rates represents a mismatch in how specific segments of the forward curve evolve, which is the defining characteristic of gap or mismatched risk in currency portfolios.

3. (C) As holding periods get longer, so do the deviations from the current market value.
The period of liquidation is vital because the potential for price fluctuation increases over time. Longer holding periods allow for greater deviations from current market values, thereby magnifying market risk exposure. Managing this timeframe helps institutions understand the potential loss they might face if an asset cannot be sold immediately at its fair market value during periods of high volatility.

4. (C) Asset liquidation risk concerns a specific asset's liquidity, while Market liquidation risk involves a market-wide crunch.
Asset liquidation risk refers to the inability to sell a specific financial instrument quickly at its fair value due to lack of buyers for that particular asset. In contrast, market liquidation risk occurs when a general liquidity shortage affects the entire financial system, making it difficult for all participants to exit positions regardless of the specific financial asset being held.

5. (B) Contraction risk, causing prepayments and forcing the reinvestment of funds at lower market rates.
Contraction risk occurs when interest rates decline, prompting borrowers to prepay their mortgages more quickly than expected. This forces the portfolio manager of mortgage-backed securities to reinvest the returned principal at the now-lower prevailing market rates. This reduction in the expected duration and yield of the investment directly negatively impacts the overall performance and value of the specialized asset portfolio.

6. (B) Credit and counterparty risk, where exposure is the liquidation value of the future cash flows.
When a counterparty experiences a credit downgrade, the institution faces credit and counterparty risk. For traded derivatives like currency swaps, the exposure is the positive mark-to-market value, representing the cost of replacing the contract's future cash flows if the counterparty defaults. The downgrade increases the probability of such a default, directly impacting the current value of the existing transaction.

7. (B) Rapid expansion in trading activity and the diversity of financial instruments traded
The growth in risk management importance is primarily driven by the massive expansion in global trading volumes and the increasing complexity of financial instruments. As banks shifted from traditional lending toward active market participation, the exposure to volatile price movements, interest rates, and foreign exchange fluctuations necessitated sophisticated frameworks to measure, monitor, and mitigate potential financial losses effectively and efficiently.

8. (B) In a well-diversified portfolio, the specific or idiosyncratic risk stands eliminated very substantially.
Diversification reduces specific or idiosyncratic risk, which is unique to an individual company

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or sector. While a factory fire significantly impacts one stock, its effect is minimized in a large portfolio containing many unrelated assets. The general market risk remains, but the unsystematic risk associated with the single production failure is largely neutralized by the performance of other holdings.

9. (B) Gap risk and the operational necessity to close out positions prior to the physical delivery date.
Gap risk occurs when forward prices for different maturities of a commodity move independently, causing mismatches in hedging or valuation. Additionally, banks often face the operational necessity to close out commodity derivative positions before the physical delivery date. This is because they generally lack the infrastructure, such as warehouses or transport systems, required to handle the actual physical goods.

10. (C) The realization of a capital loss
Interest rates and bond prices share an inverse relationship. When market interest rates rise, the value of existing fixed-rate securities falls to align their yields with the new market environment. If an investor is forced to sell the security before its maturity date, they must accept the lower current market price, resulting in the actual realization of a capital loss.

11. (D) The Central Counterparty (CCP) via the Clearing Corporation of India
To eliminate settlement risk in inter-bank transactions, monetary authorities require the use of a Central Counterparty. In India, the Clearing Corporation of India acts as this intermediary, guaranteeing the settlement of trades. By interposing itself between buyers and sellers, the CCP ensures that the failure of one party to deliver does not result in loss for the other.

12. (A) P-3, Q-2, R-4, S-1
Held to Maturity assets provide a cushion from valuation changes, while the trading book consists of Available for Sale and Held for Trading categories. The banking book's underlying principle is buy and hold, whereas marking to market involves repricing the portfolio to reflect current asset prices. These classifications help banks manage interest rate sensitivity and regulatory capital requirements for different assets.

13. (B) (I), (II), and (IV)
Foreign exchange risk focuses on downside movements even if profits are possible. Exchange rates are time-dependent, meaning spot and forward rates differ. Gap risk in currency markets is driven by spot rate movements and interest rate differentials between two countries. It does not arise from parallel movements; instead, it stems from non-parallel changes across the spectrum of exchange rate maturities.

14. (D) Assertion (A) is false, but Reason (R) is true.
The assertion is false because determining interest rate risk requires recognizing that yield curves rarely shift in a perfectly parallel or flat manner. The reason is true as yield curves are dynamic and change over time due to varying supply and demand across maturities. This non-parallel movement creates yield curve risk, which complicates the valuation and hedging of interest-sensitive portfolios.

15. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
For derivatives, credit risk exposure is measured by potential future value over the instrument's life. This metric accounts for all future cash flows that a defaulted counterparty would fail to pay. Since derivative values fluctuate, the current exposure may not reflect total risk, making it necessary to estimate the maximum possible replacement cost during the remaining term of the contract.

16. (A) Potential losses in on-and-off balance-sheet positions due to adverse market price movements
Market risk is defined as the potential for losses in both on-balance-sheet and off-balance-sheet positions resulting from adverse movements in market prices. These prices include interest rates, equity prices, foreign exchange rates, and commodity prices. Managing this risk is crucial for banks as it directly impacts earnings and capital levels due to the volatility of actively traded financial instruments.

NODIA

Oct/Nov 2024

63. Read the following statements regarding factors to be considered in scenario analysis and stress testing:

I Prices and interest rates
II Volatilities and market liquidity
III Historical correlations and assumptions in stressed market conditions
IV The institution's vulnerability to worst-case scenarios
V The default of a large counterparty and maximum cash inflow and outflow assumptions

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (V)
(B) (I), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (III), (IV), and (V)

May/June 2017

64. A Front Office dealer concludes a transaction and then attempts to reconcile a discrepancy in the nostro account to hide an error. Which principle is being violated?

(A) The principle of 'immunization', potentially leading to reinvestment risk.
(B) The principle of 'buy and hold', potentially leading to immediate capital loss.
(C) The segregation of duties, potentially leading to fraud or unrecorded risk.
(D) The 'mark-to-market' principle, leading to a systemic liquidity crunch.

Oct/Nov 2005

65. What is the direct consequence of exchange rate volatility from a risk management perspective?

(A) It permanently eliminates the gap risk in forward contracts.
(B) It creates foreign exchange risk and downside concerns despite profit potential.
(C) It causes the banking book to be automatically repriced on an intra-day basis.
(D) It stabilizes the consumer price index of the respective countries.

May/June 2020

66. A commercial bank conducts a stress test projecting extraordinary losses. How should the Board and senior management utilize the results?

(A) They should ignore results since they stem from low-probability adverse scenarios.
(B) They should immediately liquidate the entire banking book to avoid realization of loss.
(C) They should alter parameters until the model projects a net profit for reputation.
(D) They should consider results when reviewing policies and may introduce contingency plans.

Oct/Nov 2015

67. A bank's commodity desk enters into a massive derivative contract involving agricultural commodities. As the settlement date approaches, the desk realizes that accepting physical delivery would require extensive warehousing facilities. What operational aspect of commodity risk must the bank execute to mitigate this issue?

(A) The bank must convert the agricultural commodity into a base metal with a higher price-to-weight ratio.
(B) The bank should shift the contract to the banking book to delay the maturity date indefinitely.
(C) The bank should invoke sovereign immunity to cancel the contract unilaterally.
(D) The bank must exercise its necessity to close out the positions before delivery.

May/June 2013

68. In which year did the emerging importance of market risk lead the Basel Committee to amend the Basel I Accord to include market risk for capital adequacy purposes?

(A) 1988
(B) 1990
(C) 1996
(D) 2004

Oct/Nov 2021

69. Match the classification categories in List I with their intent in List II.

List I: (Classification Category)
P. Held to Maturity (HTM)
Q. Held for Trading (HFT)
R. Available for sale (AFS)
S. Market Risk
List II: (Intent)

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25. (B) The spot exchange rate of two currencies
Exchange rate risk in a foreign exchange portfolio primarily depends on the movement of the spot exchange rate between two currencies. While forward rates and interest rate differentials are important for valuation and hedging, the immediate exposure to loss or gain is driven by changes in the current market price at which one currency can be exchanged for another in the spot market.

26. (D) Assets in the trading book are held for a relatively shorter period and are marked to market, unlike the banking book.
The trading book consists of assets held for shorter periods with the intent of profiting from price changes; these assets are regularly marked to market. In contrast, the banking book holds assets like loans or held-to-maturity securities for longer terms, primarily to earn steady interest income. These banking book assets are typically not subject to daily market-based revaluation for accounting purposes.

27. (A) Lowering a credit rating increases the spread over the risk-free rate, leading to a decline in price.
Credit risk for traded debt instruments is reflected in the yield spread over the risk-free rate. When a rating agency downgrades an issuer, the market perceives higher risk, leading to an increased spread. Since yield and price are inversely related, this widening spread causes the market price of the debt to decline, resulting in a loss for the security holder.

28. (C) Both (I) and (II)
Price risk and reinvestment risk generally move in opposite directions when interest rates change. For example, rising rates decrease the price of a bond but increase the yield on reinvested coupons. Immunization is a portfolio strategy that balances these two opposing effects to protect the total return against interest rate fluctuations, ensuring the portfolio's value meets a specific future target or obligation.

29. (C) Regulators typically prohibit banks from taking direct exposures in physical commodity or derivative markets.
The claim that regulators strictly prohibit banks from taking direct exposures in physical commodity or derivative markets is incorrect. While there are stringent controls, banks may participate in these markets or finance large entities involved in commodities under specific guidelines. Managing a commodity book requires careful monitoring of directional risk and the operational necessity to close positions before physical delivery is required.

30. (A) (I) and (II) only
Basis risk occurs when the prices of a financial instrument and its corresponding hedge move in a non-parallel or adverse manner. It represents the gap between the values of the portfolio and the hedging instrument. This risk is not eliminated by a perfect parallel shift in the yield curve; instead, it is often caused by factors that prevent such parallel price movements.

31. (C) Executing daily buy, sell, and hedging operations to book trading profits
The Asset-Liability Management Committee is responsible for high-level balance sheet planning, articulating funding policies, and reviewing economic impacts on the bank's risk profile. It sets the overall strategy and risk-return goals. However, the daily execution of buying, selling, and hedging trades to generate profit is the specific function of the Front Office or Dealing Room, not the oversight committee.

32. (C) Both (I) and (II)
Institutions should implement internal capital allocation systems that link risk identification and monitoring to economic capital. This ensures that capital levels are commensurate with the market risks being assumed. Additionally, any significant changes in the size or scope of an institution's activities must trigger a thorough analysis to ensure that the existing capital base remains adequate to support those new risk levels.

33. (B) Validation and testing were not performed by personnel independent of the model's design.
A critical control failure occurred because the model was not validated by personnel independent of the design process. According to model risk management principles, the same individual who develops a quantitative model should not be the one to approve or deploy it without a secondary, objective review. This

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17. (A) Assured elimination of settlement risk for all high-volume inter-bank currency transactions
Liquidation risk involves the inability to exit a position at a fair market price due to low trading volume or market disruptions. While it leads to adverse price changes and the inability to find buyers, it does not assure the elimination of settlement risk. Settlement risk is a separate concern relating to the actual exchange of payments and assets after a trade.

18. (A) The bonds should be placed in the trading book subject to daily mark-to-market valuation, while the home loans remain in the banking book.
Assets intended for short-term trading to profit from price fluctuations must be placed in the trading book and marked to market daily. In contrast, standard long-term assets like home loans, which are held for steady interest income until maturity, belong in the banking book. This separation ensures that the different risk profiles and valuation requirements are appropriately managed by the bank.

19. (B) (I), (II), (IV), and (V)
Commodity prices are driven by demand and supply, with liquidity levels frequently varying and impacting volatility. Many commodities are perishable, especially in the energy and agricultural sectors. Additionally, commodities exhibit vast differences in price-to-weight ratios, such as gold compared to base metals. Transaction costs are not uniform, as they depend on logistics, storage, and the specific nature of each market.

20. (A) Price movements due to firm-specific factors like management changes or market share shifts.
Specific or idiosyncratic risk refers to the portion of an individual stock's price volatility that is caused by factors unique to that specific company. These factors include changes in management, product recalls, shifts in market share, or legal issues. Unlike systematic market risk, idiosyncratic risk can be largely mitigated through diversification by holding a broad portfolio of various unrelated securities.

21. (A) Only (I)
Settlement risk occurs when one party defaults after the other has already fulfilled its delivery obligation. This creates a risk of total loss of the principal amount. While the Reserve Bank of India implemented the Real Time Gross Settlement System, its purpose was to reduce and mitigate settlement risk rather than enhance it or make transactions more volatile and dangerous for banks.

22. (B) Assets under the HTM category are required to be marked to market on a daily basis.
The statement that Held to Maturity assets are marked to market daily is incorrect. These securities are intended to be held until they mature and are generally carried at cost or amortized cost, providing a cushion against market price fluctuations. Daily marking to market is only required for the trading book, which includes the Held for Trading and Available for Sale categories.

23. (D) Reinvestment risk — Variability in returns from reinvesting cash flows due to market rate changes.
Reinvestment risk is the variability in returns resulting from reinvesting intermediate cash flows, like coupon payments, at changing market interest rates. Contraction risk involves prepayments speeding up when rates fall, while call risk pertains to issuers redeeming bonds early. Basis risk involves non-parallel shifts in related prices. Therefore, the definition of reinvestment risk provided accurately reflects the uncertainty of future yields.

24. (D) Pure market risk stems from changes in market parameters, while liquidity risk involves price deviations due to thin trading.
Pure market risk originates from fluctuations in standard market parameters such as interest rates, exchange rates, or equity prices. Market liquidity risk, however, specifically addresses price deviations caused by the inability to execute trades in a thin or disrupted market. While pure risk assumes a liquid market, liquidity risk accounts for the additional cost or loss when markets lack sufficient depth.

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identifying these vulnerabilities, management can better prepare for extreme market conditions and ensure the institution maintains adequate capital and liquidity during crises.

42. (A) P-3, Q-4, R-1, S-2
The Board of Directors holds overall responsibility for risk management and policy setting, while the Risk Management Committee mandates practices and sets discretionary limits. The Asset-Liability Management Committee handles balance sheet planning and business strategy. Finally, the ALM Support Group consists of operating staff who perform the technical analysis, monitoring, and reporting of risk profiles through various simulations.

43. (A) (I), (II), (III), and (IV)
When setting a market risk strategy, institutions must consider prevailing economic and liquidity conditions and verify that they possess the internal expertise to manage specific market positions. They must also ensure their ability to monitor and control risk effectively while analyzing how assuming more risk would impact the overall portfolio mix. Political affiliations of counterparties are not a primary factor.

44. (D) They must be sourced independently of the Dealing Room by the Back or Middle Office.
Standard risk controls require that market rates used for revaluing trading portfolios be sourced independently of the Dealing Room. Having the Back or Middle Office obtain these rates prevents the Front Office from influencing the valuation of their own trades. This independence is a fundamental principle of financial oversight, ensuring that the mark-to-market process provides an accurate and unbiased reflection.

45. (C) Back-testing is prohibited when there are significant and unprecedented market developments.
The statement that back-testing is prohibited during significant and unprecedented market developments is incorrect. In fact, such periods are when back-testing is most critical to determine if risk models remain reliable under stress. Models should provide reasonable risk estimates, and management must understand their limitations. Regular back-testing is a mandatory requirement to verify the accuracy of potential loss measurements.

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46. (B) Perfect alignment — Utilizing theoretical outcomes that match all exhaustive data points flawlessly.
Model risk arises from flaws such as incorrect or outdated assumptions, simplifying parameters too much, or making errors when handling outlying data points. A situation where theoretical outcomes perfectly match all exhaustive data points flawlessly describes an ideal, highly accurate model rather than a source of risk. Therefore, perfect alignment is the opposite of the factors that typically contribute to model risk.

47. (B) To identify risks promptly and allow remedial action against sudden adverse market changes.
Institutions whose risk levels fluctuate significantly must monitor their risk profiles on an intra-day basis to identify potential threats as they emerge. This real-time oversight allows management to take immediate remedial action against sudden adverse market changes. Waiting for daily reports could result in substantial losses if market conditions deteriorate rapidly within a single trading day, bypassing traditional end-of-day controls.

48. (B) The Middle Office
The Middle Office is the organizational unit responsible for providing independent monitoring, measurement, and analysis of the bank's trading activities. Acting as the secretariat to the Asset-Liability Management Committee, it ensures that risk assessments are conducted without influence from the Front Office. This structure provides the necessary checks and balances to ensure that the bank's risk profile remains within the approved appetite.

49. (A) Communication — Prescribing how market risk is measured and communicated to the Board.
A robust market risk policy must include a communication framework that prescribes how risks are measured and reported to the Board. This ensures that the governing body receives timely and accurate information to

66. (D) They should consider results when reviewing policies and may introduce contingency plans.
Stress test results providing projections of extraordinary losses should be taken seriously by the Board and senior management. These results are used to review existing risk policies and may lead to the development of contingency plans or the adjustment of risk limits. By preparing for extreme scenarios, an institution can improve its resilience and ensure it has sufficient capital levels.

67. (D) The bank must exercise its necessity to close out the positions before delivery.
Since most banks lack the specialized infrastructure to handle physical commodities like agricultural goods, they must close out their derivative positions before the settlement date. This avoids the logistical challenges and costs associated with taking physical delivery, such as warehousing and transportation. Managing these dates is a critical operational component of commodity risk, ensuring that the bank's exposure remains purely financial.

68. (C) 1996
In 1996, the Basel Committee on Banking Supervision issued an amendment to the original 1988 Basel I Accord to incorporate capital requirements for market risk. This change recognized the growing importance of trading activities and the volatility of interest rates, exchange rates, and equity prices. It mandated that banks maintain a specific capital cushion to protect against potential trading book losses.

69. (A) P-2, Q-4, R-3, S-1
Held to Maturity securities are intended for long-term holding until they expire. Held for Trading assets are acquired to profit from short-term price movements. Available for Sale includes securities not strictly for trading or long-term holding. Market risk represents the potential loss to earnings or capital from changes in market variables. These classifications define how assets are valued and capital is allocated.

70. (B) Because it is the most volatile and fluid risk that changes very quickly.
Market risk requires a comprehensive management structure because it is exceptionally volatile and can change very rapidly. Unlike credit risk, which may develop over a longer period, market prices for interest rates, currencies, and equities fluctuate constantly. This fluidity means that significant losses can occur within extremely short timeframes, necessitating real-time monitoring and robust control frameworks to protect financial stability.

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58. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
Providing dealers with a comprehensive manual is essential for operational effectiveness and clarity in day-to-day activities. It is also true that this manual must include codes of conduct from bodies like FEDAI or FIMMDA. However, the requirement to include these industry standards is just one component of the manual and does not fully explain why the entire manual is critical.

59. (C) Documented procedures should spell out operational steps, and staff must be familiar with them.
To prevent limit breaches and operational errors, banks must have documented procedures that clearly outline every operational step. Staff members must be thoroughly familiar with these procedures to ensure they understand their responsibilities and the boundaries of their authority. Proper documentation and training provide a reliable framework that minimizes the risk of unauthorized trading and ensures consistent adherence to bank policies.

60. (B) Dealers may override Back Office payment controls during periods of high-volatility trading.
The statement that dealers can override Back Office payment controls during high volatility is incorrect. For sound risk management, the payment function must remain strictly independent of the trading function at all times. Allowing traders to bypass these controls would create opportunities for fraud or unrecorded losses, undermining the essential dual-control and segregation-of-duty principles that protect the institution's financial integrity.

61. (C) Available for sale (AFS) — Intention is strictly to hold till maturity
The assertion that Available for Sale securities are strictly intended to be held until maturity is incorrect. The category includes securities that the bank does not necessarily plan to trade immediately but also does not intend to hold until they mature. These assets provide flexibility, allowing the bank to sell them if needed for liquidity or to manage interest rate risk.

62. (A) P-3, Q-2, R-4, S-1
The banking book consists of assets held for relationship or steady income until maturity. The trading book contains investments held for short-term price profits. Mark-to-market is the accounting process of valuing assets based on current prices. Trading liquidity refers to the ability to exit positions without significantly impacting market prices. Correctly identifying these terms is fundamental to understanding categorization and risk.

63. (D) (I), (II), (III), (IV), and (V)
Stress testing must incorporate a wide range of factors, including extreme price and interest rate changes, shifts in volatility, and the breakdown of historical correlations. It should also evaluate the institution's vulnerability to the default of large counterparties and analyze maximum cash flow assumptions under worst-case scenarios. This comprehensive approach ensures that the institution understands the full extent of potential losses.

64. (C) The segregation of duties, potentially leading to fraud or unrecorded risk.
When a trader attempts to reconcile a nostro account, they violate the principle of segregation of duties. In a well-controlled environment, the Front Office should never have access to the reconciliation functions performed by the Back Office. This separation is vital to prevent individuals from concealing trading errors or committing fraud, ensuring that all financial records remain independent and transparently verified.

65. (B) It creates foreign exchange risk and downside concerns despite profit potential.
Exchange rate volatility is the primary source of foreign exchange risk. While price movements can lead to profits, risk management focuses on the downside potential for losses. This volatility affects the value of currency-denominated assets and liabilities, creating uncertainty in future cash flows. Managing this risk is essential for institutions to protect their earnings and capital from adverse market shifts.

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make informed decisions. Other policy aspects like authority lines and limit excess delegations must also be clearly defined and approved by the Board rather than external auditors.

50. (A) P-2, Q-4, R-1, S-3
The Front Office handles actual trades and hedging, while the Middle Office prepares independent forecasts and simulations. The Back Office maintains controls over confirmations, reconciliations, and payment systems. The Risk Management Committee is responsible for establishing risk limits and providing authorities for the Dealing Room. This clear division of duties is essential for preventing fraud and ensuring comprehensive oversight.

51. (A) 2, 3, 1
When limit excesses are identified by an independent unit, the first step is to investigate the reasons behind the breach. Following this, the incident must be formally reported to management. Finally, the institution should seek approval from the Board or senior management for any temporary excesses or to determine if a permanent limit increase is warranted based on investigative findings.

52. (A) (I) and (II) only
The Asset-Liability Management Committee is responsible for setting product pricing for deposits and advances and articulating the bank's interest rate view and business strategy. While the ALM Support Group assists with technical tasks, the specialized task of preparing back-testing programs for complex Value at Risk models is typically an independent risk management function rather than a core responsibility of ALCO.

53. (B) (I), (II), and (IV)
The Back Office is responsible for issuing and receiving all transaction confirmations and performing prompt reconciliations of vostro and nostro accounts. It also conducts revaluations and marking-to-market of exposures using independently sourced rates. While essential for operational stability, the Back Office does not structure the bank's high-level macroeconomic business strategy, as that responsibility lies with senior management and the Board.

54. (C) Elimination of management information systems (MIS) to ensure data confidentiality
A risk monitoring and control framework must include guidelines for risk-taking, processes for trading book allocation, and valuation policies for fair value adjustments. Eliminating management information systems would be detrimental, as these systems are necessary for providing the data required for risk measurement and reporting. Maintaining these systems is vital for data integrity and informed decision-making by senior bank management.

55. (A) The risk appetite, setting limits for management against unexpected losses
The most critical first step in setting a market risk strategy is establishing the risk appetite. This involves the Board determining the level of risk the institution is willing to assume to meet its business goals. Once the appetite is defined, specific limits can be set to protect the institution against unexpected losses, providing a clear boundary for management and traders.

56. (A) Deterioration of market liquidity conditions emanating from the operating environment
A robust risk management framework must account for the potential deterioration of market liquidity conditions within the operating environment. Financial markets are dynamic, and liquidity can vanish quickly during periods of stress, making it difficult to exit positions without incurring significant losses. Accounting for these shifts ensures that the bank's capital levels and contingency plans are adequate to survive extreme market conditions.

57. (A) Data consistency and the appropriateness of volatility and correlation assumptions.
Validation through back-testing should verify that the risk model's data remains consistent and that its volatility and correlation assumptions are still appropriate after a structural market shift. This process involves comparing the model's predicted losses against actual outcomes to ensure its continued reliability. Relying on outdated data without validation can lead to significant underestimation of risk and potential capital inadequacy.

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CHAPTER 14
Fixed Income Securities

Oct/Nov 2015

1. Arrange the following fixed income instruments in the chronological order of their first issuance in India, from earliest to latest:
1. Capital Indexed Bonds
2. Inflation Indexed Bonds (linked to WPI)
3. Floating Rate Bonds
4. Cash Management Bills

(A) 1, 3, 2, 4
(B) 3, 4, 1, 2
(C) 1, 4, 3, 2
(D) 3, 1, 4, 2

May/June 2018

2. How is "Yield to Maturity" (YTM) best defined in the context of bond fundamentals?
(A) The stated interest rate printed on the face of the bond and paid to the holder annually.
(B) The total amount of all periodic coupon payments accumulated over the entire life of the bond.
(C) The discount rate that equates the present value of future cash flows to the bond's market price.
(D) The fixed spread added to a benchmark base rate for determining floating rate bond payments.

Oct/Nov 2009

3. Identify the correct statement regarding the relationship between parties in a bond contract.
(A) Bondholders are the debtors, while bond issuers are the creditors.
(B) Both bondholders and bond issuers act as mutual creditors sharing default risk.
(C) Bondholders are the creditors, while bond issuers are the debtors.
(D) Bond issuers act as fiduciaries managing the equity capital of bondholders.

May/June 2024

4. The principle stating that a given amount of money today is worth more than the same amount of money in the future is fundamentally known as:
(A) Yield to Maturity
(B) Compounding Frequency
(C) Time Value of Money
(D) Discount Factor

Oct/Nov 2022

5. Based on the scenario described below, answer the following question:
An Oil Marketing Company receives special long-dated securities from the Government of India in lieu of cash subsidies. The company intends to utilize these securities for its statutory requirements and short-term funding needs. Which of the following correctly describes the regulatory treatment of these securities?
(A) They are eligible as SLR securities and cannot be used as collateral for market repo transactions.
(B) They are not eligible as SLR securities but are eligible as collateral for market repo transactions.
(C) They are eligible as both SLR securities and as collateral for market repo transactions.
(D) They are neither eligible as SLR securities nor as collateral for market repo transactions.

May/June 2007

6. An investment of \$1,000 is made at an 8% annual nominal rate. Identify the incorrect pair linking the compounding frequency to its effective interest rate after one year.
(A) Year - 8.00%
(B) Month - 8.33%
(C) Semi-annual - 8.16%
(D) Quarter - 8.24%

Oct/Nov 2011

7. What is a bond?
(A) A financial contract representing equity ownership in a government or corporate entity with rights to residual profits.

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(B) A debt instrument representing a loan from an investor to a borrower for a set period at a fixed or variable interest rate.
(C) A derivative instrument whose value is based on an underlying asset's performance, such as a stock or commodity.
(D) A short-term money market instrument strictly issued for durations less than one year to manage liquidity.

May/June 2013

8. What defines State Development Loans (SDLs)?
(A) Short-term debt instruments with original maturities of less than one year issued by State Governments.
(B) Tradeable dated securities issued by State Governments to raise loans from the market, qualifying for SLR.
(C) Non-transferable recapitalization bonds issued by the Central Government on behalf of states.
(D) Zero coupon bonds issued exclusively by states without normal auction processes.

Oct/Nov 2025

9. Which of the following most accurately describes the core process of bond valuation?
(A) Calculating the future value of the bond's par value without considering any periodic coupon payments.
(B) Determining the present value of all future interest and principal payments using a discount factor.
(C) Multiplying the annual coupon rate by the total number of years remaining until the bond reaches maturity.
(D) Determining the historical price of the bond at the time it was initially auctioned by the government.

May/June 2021

10. Consider the following statements regarding the debt market in India:
I The Indian bond market is characterized by the dominance of corporate bonds over central and state government bonds.
II Around 95 per cent of corporate debt issues are privately placed.
III Around 80 per cent of these debt issues are listed on the stock exchanges.
Which of the statements is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2006

11. Which of the following mathematical expressions is NOT associated with continuous compounding?
(A) $FV_n = PVe^{rt}$
(B) $PV_n = FVe^{-rt}$
(C) $\lim_{n\,to\,\infty}\left(1+\frac{1}{n}\right)^n = e$
(D) Discount Factor $= \left[1+\frac{r}{n}\right]^{-nt}$

May/June 2019

12. Consider the following statements regarding Cash Management Bills (CMBs):
I They are issued to meet temporary mismatches in the cash flow of the Government of India.
II They have the generic character of T-bills but are issued for maturities of exactly 364 days.
Which of the statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

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Oct/Nov 2014

13. Using the same issuance (8% 10-year bonds with a ₹ 1000 par value), if the bond follows customary semi-annual interest payments, what is the exact coupon payment received by a bondholder every six months per bond?
(A) ₹ 40
(B) ₹ 80
(C) ₹ 20
(D) ₹ 160

May/June 2010

14. Based on the scenario described below, answer the following question:
A Public Sector Bank receives Bank Recapitalization Bonds issued by the Government of India. The bank's treasury manager is calculating the limits for the bank's Held to Maturity (HTM) portfolio. How should these specific securities be treated within the portfolio limits?
(A) They are fully transferable and subject to

a 25% cap in the HTM portfolio.
(B) They are transferable but cannot be held in the HTM portfolio.
(C) They are non-transferable and can be held under the HTM portfolio without any limit.
(D) They are non-transferable and must be completely marked-to-market in the trading book.

Oct/Nov 2018

15. Consider the following variables used in the formula for Future Value and Present Value computations:
I P represents the Principal amount.
II r represents the annual nominal interest rate as a decimal.
III n represents the Time in decimal years.
Which of the statements is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2025

16. Why do investors primarily purchase bonds compared to other investment vehicles like stocks?
(A) Bonds offer predictable income and capital preservation if held until maturity.
(B) Bonds offer high capital appreciation potential linked to corporate earnings and market share growth.
(C) Bonds grant voting rights in the issuing corporate or municipal entity similar to common equity.
(D) Bonds carry sovereign guarantee irrespective of the issuing entity's specific credit rating.

Oct/Nov 2007

17. Which of the following is a fundamental assumption made for the simplicity of discussion on bond valuation?
(A) Coupon payments are reinvested at a rate equal to the bond's yield-to-maturity (YTM).
(B) The bond investor decides to sell the debt instrument in the secondary market before the maturity date.
(C) The periodic coupon payments are consumed immediately by the investor and not reinvested in any asset.
(D) Principal repayments are continually deferred to future periods through a series of roll-over contracts.

May/June 2012

18. Identify the incorrect statement regarding the corporate debt market in India.
(A) Corporate bonds carry a sovereign guarantee ensuring zero risk of default.
(B) Corporate bonds offer better interest rates to make them attractive to investors.
(C) The interest rate on corporate bonds depends upon the credit rating of the issuing entity.
(D) The segment acts as a stable source of finance when the equity market is volatile.

Oct/Nov 2023

19. The following question consists of two statements, one labeled as 'Assertion (A)' and the other as 'Reason (R)'. Examine these two statements carefully and select the correct answer using the codes given below.
Assertion (A): The required yield to maturity for a newly issued bond is typically established by investigating the yields offered on comparable bonds in the market.
Reason (R): Comparable bonds mean option-free bonds of the same credit quality and the exact same maturity.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2005

20. Which of the following is NOT a feature of Sovereign Gold Bonds (SGBs)?
(A) They are completely budgeted outside of market borrowing.
(B) Their prices are linked to the commodity price of Gold.
(C) The minimum investment limit is one gram of gold.
(D) The maximum limit of subscription per

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May/June 2006

34. Identify the correct statement regarding specific bond instruments.
(A) STRIPS are securities created by merging cash flows of multiple zero-coupon bonds into one regular G-Sec.
(B) Bonds with call/put options strictly allow only the investor to sell the bond back, completely restricting the issuer from buy-backs.
(C) Floating Rate Bonds guarantee an inflation-adjusted principal upon maturity regardless of the interest rate.
(D) State Development Bonds (SDLs) are loans raised by State Governments from the market.

Oct/Nov 2017

35. For a specific absolute change in interest rates, the proportionate increase in bond prices when rates fall exceeds the proportionate decrease in bond prices when rates rise. This dynamic illustrates which characteristic of bond pricing?
(A) The convex relationship between price and yield.
(B) The reinvestment risk of zero-coupon bonds.
(C) The parity of capital gains and losses.
(D) The direct proportionality of short-term bond volatility.

May/June 2008

36. Arrange the following fixed income instruments in chronological order from the shortest maximum original maturity to the longest typical maximum original maturity:
1. Cash Management Bills (CMBs)
2. Dated G-Secs
3. 364 day Treasury Bills

(A) 3, 1, 2
(B) 1, 3, 2
(C) 2, 3, 1
(D) 1, 2, 3

Oct/Nov 2013

37. In mathematical formulas for continuous compounding, the frequency of compounding approaches infinity based on Euler's 'e'. What is the approximate value of 'e' used in these calculations?
(A) 2.71828
(B) 3.14159
(C) 1.61803
(D) 2.30258

May/June 2015

38. Comparing Bond A (5-year maturity) and Bond B (30-year maturity), both having identical coupons and yields. Bond B has six times the maturity of Bond A. According to the principles of price-yield relationships, how does Bond B's interest rate sensitivity compare to Bond A's?
(A) Bond B has exactly six times the interest rate sensitivity of Bond A.
(B) Bond B has more than six times the interest rate sensitivity of Bond A.
(C) Bond B's sensitivity decreases in absolute terms as maturity extends.
(D) Bond B has less than six times the interest rate sensitivity of Bond A.

Oct/Nov 2012

39. Conceptually, how is the annual implied interest payment realized by an investor holding a Zero-Coupon Bond?
(A) Through monthly dividend checks mailed by the issuer.
(B) Through a separate interest accrual account linked to the WPI.
(C) Through the regular stripping and reconstitution of the bond.
(D) It is included in its face value which is paid at the maturity of the bond.

May/June 2016

40. An institutional investor holds a portfolio of option-free bonds. The central bank announces an unexpected hike in the benchmark interest rates, causing required yields across the market to rise. Based on the fundamental properties of bond pricing, what immediate impact will this have on the investor's portfolio valuation?
(A) The portfolio valuation will increase proportionally.
(B) The portfolio valuation will remain unchanged until the bonds mature.
(C) The portfolio valuation will adjust to equal exactly the total par value of the bonds.
(D) The portfolio valuation will decrease.

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List I: Bond Types
P. Fixed Rate Bonds
Q. Floating Rate Bonds
R. Zero Coupon Bonds
S. Capital Indexed Bonds
List II: Features
1. Variable coupon rate re-set at pre-announced intervals
2. Principal is linked to an accepted index of inflation
3. Coupon rate is constant for the entire life of the bond
4. Issued at a discount and redeemed at face value
(A) P-3, Q-1, R-4, S-2
(B) P-1, Q-3, R-2, S-4
(C) P-4, Q-2, R-1, S-3
(D) P-3, Q-4, R-1, S-2

Oct/Nov 2010

29. Based on the standard nomenclature of a typical dated fixed coupon G-Sec, identify the correct pair matching the component to its meaning for the security "7.17% GS 2028".
(A) 7.17% - Minimum amount of issue
(B) GS - Guarantee Status
(C) 2028 - Maturity Year
(D) 7.17% - Discount factor

May/June 2017

30. Consider the following statements regarding STRIPS:
I They are created by separating the cash flows associated with a regular G-Sec into separate securities.
II They are essentially Zero-Coupon Bonds (ZCBs).
III They are newly issued directly through primary auctions by the RBI.
IV They are reckoned as eligible investment for the purpose of Statutory Liquidity Ratio (SLR).
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (II), and (IV) only
(D) (I), (III), and (IV) only

Oct/Nov 2020

31. The following question consists of two statements, one labeled as 'Assertion (A)' and the other as 'Reason (R)'. Examine these two statements carefully and select the correct answer using the codes given below.
Assertion (A): In response to an increase in the required yield (market interest rate), the price of an option-free bond must decline.
Reason (R): The net present value of the bond's fixed future cash flows decreases when discounted at a higher interest rate.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2009

32. Consider the following statements regarding Zero-Coupon Bonds:
I They are also known as Pure Discount Bonds or Accrual Bonds.
II They make regular, periodic interest payments but at a substantially discounted coupon rate.
Which of the statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2008

33. Reviewing the formula for Bond Price:
$$\text{Bond Price} = \sum_{i=1}^{n} \frac{C}{(1+r)^i} + \frac{F}{(1+r)^n}$$
Identify the incorrect statement regarding the variables in this formula.
(A) The periodic coupon payment made to the bondholder based on the stated annual interest rate.
(B) The annual market interest rate multiplied by the number of years until the bond reaches maturity.
(C) The face or par value of the bond which is repaid to the investor upon the final maturity date.
(D) The total number of periods remaining until the bond reaches its final scheduled maturity.

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fiscal year is 4 kg for individuals and HUFs.

Oct/Nov 2016

21. An investor needs to accumulate exactly \$1083.28 in one year using a fixed principal amount deposited today at an 8% annual nominal rate. To minimize the initial principal required, which compounding frequency should the investor seek?
(A) Yearly
(B) Semi-annually
(C) Quarterly
(D) Daily

May/June 2023

22. Identify the correct pair linking the debt instrument to its defining characteristic.
(A) Treasury Bills - Instruments that pay a fixed floating coupon on a half-yearly basis to institutional investors.
(B) State Development Loans (SDLs) - Dated securities issued by states that qualify for SLR.
(C) Cash Management Bills - Short-term instruments issued for original maturities of one year or more.
(D) Dated G-Secs - Zero coupon securities redeemed at face value on maturity without any periodic interest.

Oct/Nov 2005

23. Match the instruments in List-I with their unique characteristics in List-II:
List I: Instruments
P. Inflation Indexed Bonds (IIBs)
Q. Bonds with Call/Put Options
R. STRIPS
S. Sovereign Gold Bonds
List II: Characteristics
1. Created by separating cash flows associated with a regular G-Sec
2. Denominated in multiples of one gram of gold
3. Feature optionality for the issuer or the investor
4. Both coupon flows and principal amounts are protected against inflation
(A) P-2, Q-3, R-1, S-4
(B) P-4, Q-3, R-1, S-2
(C) P-1, Q-4, R-2, S-3
(D) P-3, Q-1, R-4, S-2

NODIA

May/June 2014

24. When determining the cash flow of a bond, why is the process more complex for a callable bond compared to an option-free fixed-rate bond?
(A) The coupon rate of a callable bond automatically floats in direct proportion to market interest rates.
(B) The principal amount of a callable bond is linked to fluctuations in the Wholesale Price Index.
(C) The callable bond does not pay periodic interest, requiring complex continuous compounding calculations.
(D) The issuer may call the bond early, making the timing and amount of final cash flows uncertain.

Oct/Nov 2019

25. On 1st January 2021, a corporation raises a ₹ 100 crore fund for plant expansion by issuing 8% 10-year bonds with a par value of ₹ 1000 each. At maturity, what specific amount will the issuer repay for each single bond, assuming no defaults?
(A) ₹ 100
(B) ₹ 1000
(C) ₹ 1080
(D) ₹ 8000

May/June 2011

26. In what tenors are Treasury Bills (T-bills) presently issued by the Government of India?
(A) 14 day, 91 day, and 182 day
(B) 182 day, 364 day, and 728 day
(C) 45 day, 91 day, and 365 day
(D) 91 day, 182 day, and 364 day

Oct/Nov 2024

27. Which of the following represents the correct formula for the Future Value of an investment compounded at required time intervals?
(A) $FV_t = P\left(1+\frac{r}{n}\right)^{nt}$
(B) $FV_t = P\left(1+\frac{n}{r}\right)^{rt}$
(C) $FV_t = P(1+r\times n)^t$
(D) $FV_t = P\left(1-\frac{r}{n}\right)^{nt}$

May/June 2022

28. Match the types of bonds in List-I with their corresponding features in List-II:

Oct/Nov 2021

41. Identify the incorrect pair regarding the specific durations or groupings of debt instruments.
(A) T-bills present tenor - 91 days
(B) T-bills present tenor - 365 days
(C) STRIPS nature - A bundle of Zero coupon bonds
(D) Bond Price components - Sum of present value of cash flows

May/June 2020

42. A bond has a 10% coupon rate, a ₹ 1,000 par value, and matures in two years. The market rate of interest is 12%, compounded semi-annually. Upon computation, the bond's price is ₹ 965.35. Why is this bond trading at this specific price level?
(A) The market rate of interest exceeds the coupon rate, causing the bond to trade at a discount.
(B) The bond has a long maturity period which causes high price volatility in the secondary market.
(C) The prevailing market rate of interest is significantly less than the bond's stated coupon rate.
(D) The effect of semi-annual compounding always reduces the face value of the bond over its duration.

Oct/Nov 2009

43. Bonds C and D share identical 3% coupon rates and 30-year maturities. However, due to different credit ratings, Bond C currently sells at a 10% yield to maturity, while Bond D sells at a 6% yield to maturity. If market yields for both bonds decrease by 1%, which bond will show less sensitivity to this change?
(A) Bond D, because lower initial yields compress further price movements relative to high-yield bonds.
(B) Bond C, because sensitivity is inversely related to the initial yield to maturity of the bond.
(C) Bond C, because higher market yields directly amplify price volatility across all maturity profiles.
(D) Bond D, because it represents a lower overall risk profile in the eyes of most institutional investors.

NODIA

May/June 2007

44. The following question consists of two statements, one labeled as 'Assertion (A)' and the other as 'Reason (R)'. Examine these two statements carefully and select the correct answer using the codes given below.
Assertion (A): For an identical absolute change in interest rates, a bondholder will realize a greater capital gain when rates decline than capital loss when rates increase.
Reason (R): The price-yield relationship of an option-free bond exhibits convexity.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2022

45. Match the bond features in List-I with the corresponding bond type in List-II:
List I: Bond Features
P. Issued at a discount, redeemed at face value, no periodic payments
Q. Variable coupon rate re-set at intervals like six months
R. Issuer can buy-back or investor can sell during the currency of the bond
S. Coupon rate is constant till maturity
List II: Bond Types
1. Fixed Rate Bonds
2. Floating Rate Bonds
3. Zero coupon bonds
4. Bond with call/put option
(A) P-3, Q-2, R-4, S-1
(B) P-2, Q-3, R-1, S-4
(C) P-4, Q-1, R-2, S-3
(D) P-3, Q-4, R-1, S-2

May/June 2018

46. Consider the following steps for finding the market price of a bond:
I Identify the cash flows that result from owning the security.
II Determine the discount rate required to compensate the investor.
III Calculate the future value of cash flows

fresh issues to increase their risk weight to industry maximums.

May/June 2022

70. Ultimately, how does a well-developed corporate bond market assist the broader financial and banking systems?

(A) By completely replacing the need for equity markets and bank deposits within the national financial system.

(B) By providing stable finance during equity volatility, aiding ALM, and supporting long-term investment.

(C) By forcing the central bank to maintain zero-percent interest rates to support corporate borrowing costs.

(D) By eliminating the need for inflation indexing as corporate bonds outpace inflation without adjustment.

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May/June 2019

52. A corporate issuer released a bond with a 10% coupon rate. Sometime later, the central bank aggressively cuts interest rates, bringing the market rate down to 6%. How will this market environment affect the price of the previously issued 10% bond?

(A) The bond will trade at a discount because the coupon is now too high.
(B) The bond will be automatically called back by the central bank at par value.
(C) The bond price will remain unaffected as the coupon rate is fixed for the bond's life.
(D) The bond will trade at a premium because the coupon rate is higher than the market rate.

Oct/Nov 2006

53. If the price/yield relationship for an option-free bond is graphed, the resulting curve exhibits a "bowed" shape. Which of the following most appropriately describes the meaning of this specific shape?

(A) It is concave, meaning that increases in yields have bigger impacts on price than decreases in yields.
(B) It is linear, indicating a strictly proportional relationship between price and yield changes over time.
(C) It is convex, meaning decreases in yields affect prices more than equal increases in yields.
(D) It is a humped curve, showing that intermediate yield levels maximize the bond's market price.

May/June 2010

54. Which of the following is NOT a characteristic of a Zero-Coupon Bond?

(A) It is issued at a discount to its par value.
(B) Its sole return is the payment of the nominal value on maturity.
(C) A specific rate of interest is explicitly mentioned on the physical bond certificate.
(D) It is often referred to as a deep discount bond.

Oct/Nov 2014

55. A portfolio manager must choose between two 10-year bonds to maximize capital gains during an anticipated drop in interest rates. Bond M has a coupon rate of 12%, and Bond N has a coupon rate of 3%. Both are currently trading at a 10% YTM. Which bond exhibits greater relative price volatility to capitalize on the rate drop?

(A) Bond N, because prices of low-coupon bonds are more sensitive to changes in interest rates.
(B) Bond M, because higher coupon payments compound faster.
(C) Bond M, because high-coupon bonds are more sensitive to rate changes.
(D) Both bonds will exhibit identical volatility because their maturities and YTMs are the same.

May/June 2021

56. A bond has a coupon rate of 10% and a par value of ₹ 1,000. Following a shift in economic policy, the prevailing market rate of interest adjusts to exactly 10%. Without running a complex calculation, what can be definitively concluded about the new trading price of this bond?

(A) The bond will trade at a premium above ₹ 1,000.
(B) The bond will trade at a discount below ₹ 1,000.
(C) The bond will trade exactly at par value of ₹ 1,000.
(D) The price will decrease proportionally to the time remaining to maturity.

Oct/Nov 2018

57. Match the terminology in List-I to its precise definition in List-II:

List I: Terminology
P. Bond
Q. Inflation Indexed Bond
R. STRIPS
S. SDLs

List II: Definitions
1. Created by separating cash flows associated with a regular G-Sec into separate zero-coupon bonds
2. Loans raised from the market by State Governments
3. Instrument representing a loan made by an investor to an issuer for a defined period
4. Bonds where both coupon flows and principal amounts are protected against inflation

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using the nominal rate.

IV Find the present value of the cash flows estimated in step 1 using the determined discount rate.

V Subtract the par value from the present value of cash flows.

Which combination of steps represents the correct procedure?

(A) (I), (III), and (V)
(B) (I), (II), and (IV)
(C) (II), (IV), and (V)
(D) (I), (II), (III), and (IV)

Oct/Nov 2015

47. Identify the incorrect statement regarding bond types.

(A) A Fixed Rate Bond is one on which the coupon rate is fixed for the entire life of the bond.
(B) Zero coupon bonds are issued at a premium and redeemed at a discount on maturity.
(C) A Floating Rate Bond has a variable coupon rate which is re-set at pre-announced intervals.
(D) Inflation Indexed Bonds protect both coupon flows and principal amounts against inflation.

May/June 2013

48. Consider the following properties defining the relationship between price, yield, and coupon rate:

I The price of an option-free bond changes in the direction opposite to the change in the required yield.
II When the coupon rate equals the required yield, the price equals the par value.
III When the coupon rate is less than the required yield, the price is less than the par value.
IV When the coupon rate is more than the required yield, the price is more than the par value.

Which combination of these properties is correct?

(A) (I), (II), and (IV) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2011

49. When calculating the price of a zero-coupon bond to ensure consistency with a standard semi-annual coupon bond, what adjustment is made to the number of years to maturity to determine the number of periods (n) used for discounting?

(A) It is multiplied by 2.
(B) It is divided by 2.
(C) It is squared.
(D) It is left completely unchanged.

May/June 2024

50. A bank holds two bonds with identical coupon rates and initial yields. Bond A matures in 5 years, while Bond B matures in 30 years. If market interest rates increase by 2%, which bond will experience a larger percentage drop in price, and why?

(A) Bond A, because short-term bonds face higher reinvestment risk when market interest rates fluctuate.
(B) Bond A, because shorter duration tends to concentrate the discounting effect on immediate cash flows.
(C) Bond B, because higher discount rates apply to cash flows occurring further in the future.
(D) Both bonds will drop by the exact same percentage due to having identical coupon rates and initial yields.

Oct/Nov 2025

51. Consider the following entities and instruments involved in the fixed income securities market:

I Central Government issuing Treasury Bills
II Corporate entities issuing Debentures
III State Governments issuing SDLs
IV Reserve Bank of India issuing Sovereign Gold Bonds on behalf of GOI
V Food Corporation of India issuing Special Securities

Which combination of the above represents instruments constituting exposure to the fixed income market?

(A) (I), (II), and (III) only
(B) (I), (III), (IV), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

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statements carefully and select the correct answer using the codes given below.
Assertion (A): Risk managers must strike a balance using market intelligence to enhance risk-adjusted yield with proper permutations and combinations.
Reason (R): In the financial markets, there is an interplay between safety of principal (liquidity) and yield, where liquid assets generally carry low yield.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2023

64. Consider the following components used in bond analysis:
I Face value
II Coupon payment
III Maturity date
IV Yield to Maturity
V Compounding Frequency
Which combination of these components is necessary to accurately price an option-free coupon bond using the standard Present Value formula?
(A) (I), (II), and (III) only
(B) (II), (III), (IV), and (V) only
(C) (I), (II), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2005

65. Identify the incorrect statement describing the sensitivity of bond prices to maturity.
(A) Interest rate sensitivity generally increases with maturity.
(B) Interest rate risk is directly and exactly proportional to bond maturity.
(C) Long-term bonds tend to be more sensitive to interest rate changes than short-term bonds.
(D) The sensitivity of bond prices to changes in yields increases at a decreasing rate as maturity increases.

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May/June 2014

66. Which of the following is NOT a standard concept or bond type in fixed-income markets?
(A) Floating rate bond
(B) Capital indexed bond
(C) Sovereign gold bonds
(D) Mortgage-backed security

Oct/Nov 2019

67. Consider the following variables that influence the volatility of a bond's price:
I The length of time to maturity.
II The bond's coupon rate.
III The yield to maturity at which the bond currently sells.
IV The face value of the bond printed on the certificate.
Which of these variables directly dictate the percentage price sensitivity of a bond to interest rate changes?
(A) (I), (II), and (III) only
(B) (I), (II), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

May/June 2011

68. Consider the following statements regarding the pricing of an option-free bond:
I When the coupon rate equals the required yield, the price equals the par value.
II When the coupon rate is more than the required yield, the price is less than the par value.
Which of the statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2024

69. Identify the correct statement regarding a bank's exposure to fixed income securities.
(A) Fixed income securities are totally exempt from interest rate risk when held in a bank's HTM portfolio.
(B) Bonds are a major component of the investment portfolio, including exposure to the trading book.
(C) A bank's investment portfolio is primarily dominated by equity stocks rather than debt-based instruments.
(D) Government securities are rolled over with

25. (B) ₹ 1000
At the end of a bond's term, the issuer is obligated to repay the original face value or par value to the holder. In the case of a bond with a ₹ 1,000 par value, this specific amount is the principal returned at maturity, regardless of the annual coupon payments received during the bond's life. This final payment marks the completion of the debt contract.

26. (D) 91 day, 182 day, and 364 day
Treasury Bills are short-term debt instruments issued by the Central Government to manage liquidity and meet short-term funding needs. Currently, the Government of India issues these zero-coupon securities in three specific standard tenors: 91 days, 182 days, and 364 days. These instruments are issued at a discount and redeemed at their full face value upon reaching their respective maturity dates.

27. (A) $FV_t = P\left(1 + \frac{r}{n}\right)^{nt}$
The standard mathematical formula for calculating the future value of an investment involves the principal, the nominal interest rate, the compounding frequency, and the time in years. By dividing the annual rate by the number of periods and raising the total to the power of the product of frequency and years, one can determine the accumulated value over any duration.

28. (A) P-3, Q-1, R-4, S-2
Fixed Rate Bonds maintain a constant coupon throughout their life, while Floating Rate Bonds feature periodic interest resets. Zero Coupon Bonds are unique because they are issued at a discount and pay no intermediate interest, providing returns upon redemption. Capital Indexed Bonds specifically link the principal amount to an inflation index to protect the investor's purchasing power against rising prices.

29. (C) 2028 - Maturity Year
Government securities in India follow a specific naming convention that identifies their key characteristics. For a security labeled 7.17% GS 2028, the percentage represents the fixed annual coupon rate, and GS stands for Government Security. The numeric year 2028 explicitly denotes the final maturity year when the principal amount will be repaid to the investors by the central government.

30. (C) (I), (II), and (IV) only
STRIPS are created through the process of stripping a standard dated government security into its individual coupon and principal components, which then trade as separate zero-coupon bonds. While they are eligible for the Statutory Liquidity Ratio, they are not newly issued directly through primary auctions. Instead, they are derived from existing securities through a specific administrative process within the central bank's systems.

31. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
There is an inverse relationship between the price of an option-free bond and market interest rates. When the required yield increases, the fixed future cash flows of the bond must be discounted at this higher rate. Mathematically, this results in a lower net present value, causing the market price of the bond to decline to reflect the new yield environment.

32. (A) Only (I)
Zero-coupon bonds, often called pure discount or accrual bonds, do not make any periodic interest payments to the holder. Instead of regular coupons, these instruments are issued at a significant discount to their face value. The investor's return is realized as the difference between the low purchase price and the full par value paid by the issuer at maturity.

33. (B) The annual market interest rate multiplied by the number of years until the bond reaches maturity.
In the bond pricing formula, the variable r represents the periodic discount rate or yield, not a product of rate and time. The formula relies on discounting each individual cash flow by the rate raised to the power of the period number. Multiplying the rate by maturity is a misunderstanding of how the present value of future payments is mathematically derived.

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ANSWERS

1. (D) 3, 1, 4, 2
India introduced various fixed income instruments to diversify its debt market over several decades. Floating Rate Bonds were first issued in 1995, followed by Capital Indexed Bonds in 1997. Later, Cash Management Bills were introduced in 2010 to manage temporary cash flow mismatches. Finally, Inflation Indexed Bonds linked to WPI were launched in 2013 for retail investors.

2. (C) The discount rate that equates the present value of future cash flows to the bond's market price.
Yield to Maturity represents the internal rate of return for a bond, assuming all payments are made as scheduled and the investor holds the security until its maturity date. It functions as the specific discount rate that makes the present value of all expected future cash flows equal to the current market price of the instrument being evaluated.

3. (C) Bondholders are the creditors, while bond issuers are the debtors.
A bond serves as a formal legal agreement representing a loan from an investor to an entity. In this financial arrangement, the bondholders act as creditors who provide capital, while the bond issuers serve as debtors who are obligated to repay the principal and interest. This distinguishes debt instruments from equity, which represents ownership rather than credit.

4. (C) Time Value of Money
The Time Value of Money is a core financial principle asserting that the purchasing power and utility of currency decrease over time due to potential earning capacity and inflation. This concept dictates that funds available today are worth more than the identical sum in the future, necessitating the use of discounting techniques when valuing long-term financial instruments.

5. (B) They are not eligible as SLR securities but are eligible as collateral for market repo transactions.
Special securities issued by the government to entities like oil marketing companies or fertilizer companies in lieu of cash subsidies differ from standard government securities. While these instruments are sovereign in nature, they typically do not qualify for the Statutory Liquidity Ratio. However, they remain tradeable and are eligible as collateral for market repo transactions for liquidity management.

6. (B) Month - 8.33%
Effective interest rates vary depending on the frequency of compounding within a single year. For an 8% nominal rate, annual compounding yields 8.00%, semi-annual yields 8.16%, and quarterly yields 8.24%. Monthly compounding actually results in an effective rate of approximately 8.30%, making the 8.33% figure mathematically incorrect when calculated using standard future value formulas for periodic compounding.

7. (B) A debt instrument representing a loan from an investor to a borrower for a set period at a fixed or variable interest rate.
A bond is fundamentally a fixed-income instrument that functions as a contractual loan made by an investor to a borrower, such as a corporation or government. It outlines the specific terms for the repayment of the principal amount at a future maturity date, alongside periodic interest payments, which can be either fixed or variable throughout the duration.

8. (B) Tradeable dated securities issued by State Governments to raise loans from the market, qualifying for SLR.
State Development Loans are dated securities issued by various state governments in India to raise funds from the open market. These instruments are tradeable in the secondary market and are issued through auctions conducted by the central bank. Crucially, they

NODIA

(A) P-3, Q-4, R-1, S-2
(B) P-1, Q-2, R-3, S-4
(C) P-4, Q-3, R-2, S-1
(D) P-3, Q-1, R-4, S-2

May/June 2012

58. A financial analyst is evaluating three different bonds: Bond X (Coupon 6%, Market Yield 8%), Bond Y (Coupon 8%, Market Yield 8%), and Bond Z (Coupon 10%, Market Yield 8%). All have the same par value and maturity. Based on price-yield properties, what will be their relative trading statuses?
(A) Bond X trades at a discount, Bond Y at par, Bond Z at a premium.
(B) Bond X trades at par, Bond Y at a premium, Bond Z at a discount.
(C) Bond X trades at a premium, Bond Y at a discount, Bond Z at par.
(D) All three bonds trade at par because they share the same market yield.

Oct/Nov 2007

59. An investor is pricing a zero-coupon bond that matures in 10 years and has a maturity value of ₹ 1,000. The required annual yield is 8%. Using semi-annual discounting (quasi-coupon period), what is the correct formula setup to find the price of this bond?
(A) $\text{Price} = \frac{1000}{(1+0.08)^{10}}$
(B) $\text{Price} = \frac{1000}{(1+0.08)^{20}}$
(C) $\text{Price} = \frac{1000}{(1+0.04)^{20}}$
(D) $\text{Price} = \frac{1000}{(1+0.04)^{10}}$

May/June 2025

60. Match the properties of bond price volatility in List-I with their corresponding descriptions in List-II:
List I: Volatility Property
P. Sensitivity and Maturity
Q. Sensitivity Growth Rate
R. Sensitivity and Coupon Rate
S. Sensitivity and Initial Yield
List II: Descriptions
1. Interest rate risk is inversely related to the bond's coupon rate.
2. Prices of long-term bonds tend to be more sensitive to interest rate changes than short-term bonds.
3. Sensitivity of a bond's price to a change in yield is inversely related to the yield to maturity at which the bond currently sells.
4. Sensitivity of bond prices to changes in yields increases at a decreasing rate as maturity increases.
(A) P-2, Q-4, R-1, S-3
(B) P-4, Q-2, R-3, S-1
(C) P-1, Q-3, R-2, S-4
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2023

61. Consider the following statements regarding coupon rates and interest rate risk:
I Interest rate risk is directly related to the bond's coupon rate.
II Prices of low-coupon bonds are more sensitive to changes in interest rates than prices of high-coupon bonds.
III A lower-coupon bond exhibits greater sensitivity to changes in interest rates, turning out to be a general property of bond prices.
Which of the statements is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2005

62. Judged by total market value, why do fixed-income securities constitute the most prevalent means of raising capital globally?
(A) They provide a simple way for entities to raise capital and offer investors a low-risk alternative to stocks.
(B) They grant direct managerial control of corporations to the bondholders through specific covenant clauses.
(C) They are completely immune to interest rate risks and default risks because of the legal priority of debt.
(D) They exclusively use continuous compounding models to guarantee exponential returns on the invested capital.

Oct/Nov 2016

63. The following question consists of two statements, one labeled as 'Assertion (A)' and the other as 'Reason (R)'. Examine these two

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17. (A) Coupon payments are reinvested at a rate equal to the bond's yield-to-maturity (YTM).
Standard bond valuation models often rely on the simplifying assumption that all periodic coupon payments are immediately reinvested at a rate equal to the bond's current yield to maturity. This allows for a consistent mathematical calculation of total returns. In reality, reinvestment rates fluctuate over time, but this assumption provides a baseline for comparing the relative value of different securities.

18. (A) Corporate bonds carry a sovereign guarantee ensuring zero risk of default.
Corporate bonds are debt instruments issued by private or public corporations and, unlike government securities, they do not carry a sovereign guarantee. Instead, their risk profile and interest rates are determined by the credit rating of the issuing entity. While they offer higher yields to compensate for default risk, they are not zero-risk investments like central government-backed debt instruments.

19. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
When pricing a newly issued bond, market participants determine the required yield by looking at the yields of similar existing securities. Comparable bonds are defined as those sharing the same credit quality, maturity, and lack of embedded options. This comparative analysis ensures that the new issue is priced competitively and reflects current market conditions for debt instruments with similar risk profiles.

20. (A) They are completely budgeted outside of market borrowing.
Sovereign Gold Bonds are government securities denominated in grams of gold and serve as a substitute for physical gold investment. While they are linked to gold prices and have specific subscription limits for individuals, they are actually part of the government's overall market borrowing program. Therefore, stating that they are budgeted completely outside of market borrowing is an incorrect description.

21. (D) Daily
To reach a specific future value with a fixed interest rate, the initial principal required decreases as the compounding frequency increases. Higher frequencies, such as daily compounding, generate more interest on interest within the same timeframe compared to annual or semi-annual cycles. Consequently, daily compounding achieves the target amount with the smallest possible initial deposit among the standard frequency options.

22. (B) State Development Loans (SDLs) - Dated securities issued by states that qualify for SLR.
State Development Loans are long-term dated securities issued by state governments to fund their fiscal requirements. These instruments are tradeable and recognized as eligible for the Statutory Liquidity Ratio, making them essential for institutional portfolios. In contrast, Treasury Bills are short-term zero-coupon instruments, and Cash Management Bills are specifically designed for maturities much shorter than one year to manage cash.

23. (B) P-4, Q-3, R-1, S-2
Inflation Indexed Bonds protect both interest and principal from inflation, while bonds with call/put options include features allowing early redemption or sale. STRIPS are created by unbundling the cash flows of a regular government security into separate interest and principal components. Sovereign Gold Bonds are denominated in units of gold, providing a financial alternative to holding physical precious metals.

24. (D) The issuer may call the bond early, making the timing and amount of final cash flows uncertain.
Valuation is more complex for callable bonds because the issuer possesses the right to redeem the security before the scheduled maturity date. This embedded option makes the actual timing and total amount of future cash flows uncertain for the investor. Unlike option-free bonds with fixed payment schedules, the cash flow projections for callable bonds must account for various potential redemption scenarios.

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qualify as eligible securities for banks to meet their Statutory Liquidity Ratio requirements under current banking regulations.

9. (B) Determining the present value of all future interest and principal payments using a discount factor.
Bond valuation involves determining the fair market price of a debt security by calculating the present value of its expected future cash flows. This process requires discounting every scheduled interest payment and the final principal repayment back to the present day using an appropriate market-determined discount rate or yield that reflects the risk profile of the issuing entity.

10. (B) (II) and (III) only
The Indian debt market is predominantly led by government securities, rather than corporate bonds. However, within the corporate segment, approximately 95 percent of all debt issues are carried out through private placements rather than public offerings. Additionally, about 80 percent of these corporate debt issues are listed on stock exchanges to facilitate secondary market trading and transparency.

11. (D) Discount Factor $= \left[1 + \frac{r}{n}\right]^{-nt}$
Continuous compounding uses the mathematical constant 'e' to represent the limit of compounding as the frequency approaches infinity. While expressions involving exponential functions describe continuous growth or decay, the formula using periodic frequency variables represents discrete compounding. Specifically, the expression for the compounding factor with periodic intervals applies to finite frequencies like monthly or quarterly compounding rather than continuous.

12. (A) Only (I)
Cash Management Bills are short-term money market instruments issued by the central government to address temporary mismatches in cash flows. While they share the generic characteristics of Treasury Bills, they are distinct because they are issued for maturities of less than 91 days. Therefore, describing them as having maturities of exactly 364 days is factually incorrect regarding their specific design.

13. (A) ₹ 40
Coupon payments on fixed-income bonds are typically calculated by applying the annual interest rate to the face value of the instrument. For an 8% bond with a par value of ₹ 1,000, the total annual interest is ₹ 80. When payments are made semi-annually, this annual amount is divided into two equal installments of ₹ 40 each period.

14. (C) They are non-transferable and can be held under the HTM portfolio without any limit.
Bank Recapitalization Bonds are special securities issued to public sector banks by the government. Unlike standard government securities, these instruments are generally non-transferable and do not have an active secondary market. Because of their unique nature, they are allowed to be held in a bank's Held to Maturity portfolio without being subject to the usual percentage caps or limits.

15. (A) (I) and (II) only
In financial mathematics, P represents the principal or initial investment, and r denotes the annual nominal interest rate expressed in decimal form. However, the variable n typically represents the number of compounding periods or total duration in cycles, whereas t usually denotes time in years. This distinction is vital for accurately calculating future value and present value across different frequencies.

16. (A) Bonds offer predictable income and capital preservation if held until maturity.
Investors choose bonds primarily because they provide a steady and predictable stream of income through periodic interest payments. Unlike equity, which carries higher volatility and residual risk, bonds offer better capital preservation if held until maturity. This makes them suitable for risk-averse individuals or institutions seeking to balance their portfolios with stable assets and defined cash flow schedules.

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34. (D) State Development Bonds (SDLs) are loans raised by State Governments from the market.
State Development Loans are the primary market-borrowing instruments used by state governments to fund their fiscal deficits. Unlike other descriptions, this accurately identifies them as loans raised directly from the market. Other instruments like STRIPS involve stripping existing bonds rather than merging them, and floating rate bonds focus on variable interest rather than inflation-adjusted principal.

35. (A) The convex relationship between price and yield.
The price-yield relationship for option-free bonds is not linear; it is convex. This mathematical property ensures that for a given change in yields, the percentage increase in price when rates fall is greater than the percentage decrease when rates rise by the same amount. Convexity is a favorable attribute for bondholders as it provides a cushion during periods of interest rate volatility.

36. (B) 1, 3, 2
Fixed income instruments vary significantly in their maximum tenors. Cash Management Bills are the shortest, typically issued for periods less than 91 days. Treasury Bills follow with standardized tenors reaching up to 364 days. Dated Government Securities represent the longest category, with original maturities often ranging from several years up to forty years, depending on the government's long-term funding requirements.

37. (A) 2.71828
Euler's number, denoted as e, is a fundamental mathematical constant used extensively in finance for continuous compounding calculations. Its approximate value is 2.71828. This irrational number represents the base of natural logarithms and describes the limit of growth when interest is compounded more and more frequently, eventually reaching a state of continuous accumulation over time.

38. (D) Bond B has less than six times the interest rate sensitivity of Bond A.
While interest rate sensitivity generally increases as the maturity of a bond extends, the rate of increase is not strictly proportional. Consequently, a 30-year bond will be more sensitive to yield changes than a 5-year bond, but its sensitivity will be less than six times that of the shorter bond. This illustrates that price volatility increases at a decreasing rate.

39. (D) It is included in its face value which is paid at the maturity of the bond.
Investors in zero-coupon bonds do not receive periodic cash interest. Instead, the total interest earned over the life of the bond is built into the difference between the discounted purchase price and the face value. This total accrued interest is realized only when the issuer pays the full nominal value of the security upon its final maturity date.

40. (D) The portfolio valuation will decrease.
When market interest rates rise, the required yield on all bonds increases to match the new economic environment. For existing option-free bonds with fixed coupons, this leads to an immediate decline in their market prices because their fixed payments are now less attractive. Consequently, an institutional investor's portfolio valuation will decrease following a central bank's announcement of a rate hike.

41. (B) T-bills present tenor - 365 days
Treasury Bills in India are issued in specific, standardized tenors. While 91-day and 182-day versions exist, the longest standard tenor is 364 days, not 365 days. Identifying 365 days as a present tenor is factually incorrect within the context of Indian money market instruments. The other pairs accurately describe the nature of STRIPS and the components of bond pricing.

42. (A) The market rate of interest exceeds the coupon rate, causing the bond to trade at a discount.
A bond trades at a discount when its fixed coupon rate is lower than the prevailing market interest rate for similar securities. In this scenario, a 10% coupon bond must be priced below its par value to offer investors a competitive 12% yield. The price adjustment compensates the buyer for the lower interest payments received compared to newer market issues.

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(D) Because the percentage price change relies exclusively on early cash flows of convex bonds

Oct/Nov 2024

29. All of the following are recognized advantages of the Price Value of a Basis Point (PVBP) measure EXCEPT:
(A) The metric remains relatively straightforward and simple for practitioners to calculate
(B) It has gained widespread acceptance with dealers intuitively
(C) It perfectly accounts for non-parallel shifts across the entire yield curve
(D) It can be amalgamated across all cash flows from a portfolio of transactions

May/June 2016

30. Which of the following statements correctly identifies a price volatility characteristic of bonds?
(A) The percentage price change is exactly the same for all bonds for any given change in yield
(B) For small changes in required yield, the percentage price change is significantly different depending on whether the yield increases or decreases
(C) For large changes in required yield, the percentage price change is exactly the same for an increase as it is for a decrease
(D) For a given large change in basis points in the required yield, the percentage price increase is greater than the percentage price decrease

Oct/Nov 2012

31. Which of the following is the correctly matched pair regarding the price volatility characteristics of bonds?
(A) Percentage price change is exactly the same for all bonds
(B) For large changes in required yield, the percentage price change is exactly identical for increases and decreases
(C) For small changes in required yield, percentage price change is roughly the same whether yield increases or decreases
(D) For a given large change in yield, the percentage price decrease is greater than the percentage price increase

May/June 2023

32. Consider the following statements regarding interest rate risk measurement:
I Methods to measure interest rate risk can be broadly classified as sensitivity approach and value at risk approach.
II The sensitivity approach measures the change in bond price in response to a unit change in yield.
III PVBP measures the rupee change in the price of a bond for a ten basis point change in yield.
IV The portfolio PVBP is simply the unweighted mathematical average of individual PVBPs.
V Duration provides a good estimate of the volatility of the market value of a bond portfolio to interest rate changes.
Which of the above statement(s) is/are correct?
(A) (I), (III), and (IV)
(B) (I), (II), and (V)
(C) (II), (IV), and (V)
(D) (I), (II), (III), and (V)

Oct/Nov 2009

33. Match the variables in the Effective Convexity formula with their definitions in List II.
List I: (Variables)
P. V+
Q. V-
R. V_0
S. Δy
List II: (Definitions)
1. Change in market interest rate used to calculate new values
2. Initial price per 100 of par value
3. Price if yield is increased by change in yield
4. Price if yield is decreased by change in yield
(A) P-3, Q-4, R-2, S-1
(B) P-4, Q-3, R-1, S-2
(C) P-3, Q-2, R-4, S-1
(D) P-2, Q-1, R-3, S-4

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May/June 2010

34. The following questions consist of two statements — Assertion (A) and Reason (R). Answer these questions selecting the appropriate option.
Assertion (A): Hedging a bond position allows

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52. (D) The bond will trade at a premium because the coupon rate is higher than the market rate.
When market interest rates drop below the fixed coupon rate of an existing bond, that bond becomes more valuable to investors seeking higher returns. In this scenario, the 10% coupon bond will trade at a premium because it offers better interest payments than the new market rate of 6%. The market price rises until the bond's yield matches the current environment.

53. (C) It is convex, meaning decreases in yields affect prices more than equal increases in yields.
The bowed shape of the price-yield curve for option-free bonds represents convexity. This means the curve is always bending away from the origin. A key implication of this shape is that a decrease in yields will result in a larger absolute increase in the bond's price compared to the price decrease caused by an equal increase in market yields.

54. (C) A specific rate of interest is explicitly mentioned on the physical bond certificate.
Zero-coupon bonds are defined by the absence of periodic interest payments, and therefore, no explicit coupon rate is printed on the physical certificate. Instead, these instruments are characterized by being issued at a deep discount to their par value. The return is entirely derived from the price appreciation between the purchase date and the final maturity date of the bond.

55. (A) Bond N, because prices of low-coupon bonds are more sensitive to changes in interest rates.
Lower-coupon bonds exhibit higher interest rate sensitivity compared to higher-coupon bonds of the same maturity and yield. This is because a larger portion of the low-coupon bond's total value is concentrated in the final principal repayment. Therefore, Bond N, with a 3% coupon, will show greater relative price volatility and provide higher capital gains during a period of falling rates.

56. (C) The bond will trade exactly at par value of ₹ 1,000.
There is a direct mathematical relationship between a bond's coupon rate, its required market yield, and its price. When the prevailing market interest rate is exactly equal to the bond's stated coupon rate, the present value of all future cash flows will equal the bond's face value. Consequently, the bond will trade exactly at par without any discount or premium.

57. (A) P-3, Q-4, R-1, S-2
A bond is a general debt instrument representing a loan. Inflation Indexed Bonds specifically protect interest and principal from rising prices. STRIPS are created by unbundling the various cash flows of a government security into separate zero-coupon units. State Development Loans are the specific market-based borrowing instruments used by state governments to fund their various fiscal and developmental expenditures.

58. (A) Bond X trades at a discount, Bond Y at par, Bond Z at a premium.
A bond's price status is determined by comparing its coupon rate to the market yield. Bond X, with a 6% coupon below the 8% yield, will trade at a discount. Bond Y, with an 8% coupon matching the yield, will trade at par. Bond Z, with a 10% coupon above the yield, will trade at a premium to its face value.

59. (C) Price $= \dfrac{1000}{(1+0.04)^{20}}$
When pricing a zero-coupon bond using semi-annual conventions, the annual yield is divided by two to get the periodic rate, and the number of years is multiplied by two to get the total number of periods. For a 10-year bond at an 8% yield, this results in a discount rate of 4% applied over twenty distinct semi-annual periods.

60. (A) P-2, Q-4, R-1, S-3
Long-term bonds are more sensitive than short-term ones, though this sensitivity increases at a decreasing rate as maturity extends. Additionally, interest rate risk is inversely related to both the coupon rate and the initial yield to maturity. These properties define how various bond characteristics influence price volatility in response to fluctuations in market interest rates over the life of the instrument.

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rate
(C) For bonds selling at a high discount, duration may decrease with increasing maturity
(D) Holding other factors constant, the duration of a coupon bond is lower when the bond's yield to maturity is lower

Oct/Nov 2025

15. Which of the following provides the most accurate definition of Liquidation Risk in the context of bond portfolios?
(A) The uncertainty about the rate at which interim coupons can be reinvested before maturity
(B) The probability that the bond issuer will default on its principal payment obligation
(C) The risk that an embedded call option will be exercised by the issuer prematurely
(D) The uncertainty about the price at which a bond can be sold prior to maturity at a specific time

May/June 2013

16. What is the definition of reinvestment risk?
(A) The uncertainty about what yields will prevail at the time of an interim cash flow
(B) The uncertainty about the price of an instrument at the time it needs to be liquidated
(C) The uncertainty about the creditworthiness of the bond issuer before the maturity date
(D) The uncertainty regarding the change in the fundamental duration of a bond portfolio

Oct/Nov 2018

17. All of the following statements describe the properties of duration EXCEPT:
(A) Given a specific coupon, a bond with a shorter maturity generally has a higher duration
(B) At higher yields, a higher fraction of the total value of the bond lies in earlier payments, reducing effective maturity
(C) The duration of a zero-coupon bond is exactly equal to its term to maturity
(D) Holding other factors constant, the duration of a coupon bond is higher when the bond's yield to maturity is lower

May/June 2006

18. Which equation represents the Modified Duration (MD) assuming semiannual compounding, where D is duration and y is the yield?
(A) $MD = D / (1 + y/2)$
(B) $MD = D / (1 + y)$
(C) $MD = D \times (1 + y/2)$
(D) $MD = D / (2 + y)$

Oct/Nov 2010

19. Which of the following statements regarding bond portfolio management and risk is INCORRECT?
(A) Bank liabilities are primarily short-term customer deposits and consequently have low duration
(B) Reinvestment risk is the uncertainty about what yields will prevail at the time of an interim cash flow
(C) Unexpected bond price changes cause reinvestment risk and liquidation risk
(D) Target date immunization ensures a stream of fixed outflows can be met from available liabilities

May/June 2025

20. Which of the following is a correct statement regarding matching both duration and convexity between assets and liabilities?
(A) It sets the initial change in interest rate sensitivity of the assets equal to that of the liabilities
(B) It requires the asset-liability manager to rebalance the portfolio much more frequently than matching duration alone
(C) It causes changes in the value of assets to diverge significantly from changes in the value of liabilities
(D) It works exclusively for short volatility positions where negative convexity is strictly maintained

Oct/Nov 2005

21. Arrange the following steps chronologically to compute the PVBP of a bond:
I Assume the yield changes by 1 basis point and compute the new price of the bond.
II Find out the change in the price of the bond as a result of the 1 basis point change.
III Compute the present value or price of the

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for active market engagement and the HTM portfolio for long-term stability. This exposure is critical for managing liquidity, meeting regulatory requirements, and generating interest income from the bank's available capital.

70. (B) By providing stable finance during equity volatility, aiding ALM, and supporting long-term investment.
A deep and liquid corporate bond market provides a stable alternative source of funding for businesses, especially when equity markets are volatile. It helps banks and financial institutions manage their asset-liability mismatches by providing long-dated instruments. Furthermore, it supports national economic growth by channeling savings into long-term infrastructure and industrial projects that require extended financing periods beyond typical bank loans.

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CHAPTER 15
Measurement of Interest Rate Risk

Oct/Nov 2023

1. When utilizing the Price Value of a Basis Point (PVBP) to measure interest rate risk, what assumption is made regarding the movement of the yield curve?

(A) The yield curve moves up or down in a non-linear convex manner
(B) The yield curve steepens significantly at the longer end
(C) The yield curve flattens completely across all maturities
(D) The yield curve moves up or down in a parallel manner

May/June 2012

2. Which of the following statements regarding convexity is INCORRECT?

(A) The bigger the move in interest rates in either direction, the greater the gains from positive convexity
(B) Convexity is the rate of change of duration with yield
(C) Modified duration is the second derivative of price with respect to yield
(D) Plain vanilla bonds generally display positive convexity

Oct/Nov 2015

3. How is an immunized portfolio defined in the context of interest rate risk?

(A) A portfolio that strictly contains short-term government securities with zero default risk
(B) A portfolio whose overall duration is perfectly matched with the average maturity of the market index
(C) A portfolio that remains unaffected by interest rate changes
(D) A portfolio that generates a higher yield than the prevailing market interest rate

May/June 2024

4. What is the most appropriate primary objective of hedging a bond position using Basis Point Values (BPVs)?

(A) To maximize the capital gains from the overall portfolio through strategic asset allocation
(B) To increase the duration of the combined portfolio to capture long-term yield premiums
(C) To match the price change of the primary instrument with that of the hedging instrument
(D) To eliminate reinvestment risk entirely without affecting the portfolio's expected rate of return

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Oct/Nov 2007

What drives negative convexity in callable bonds during a falling interest rate environment?

(A) The sudden inability of the debt issuer to maintain required coupon payments to bondholders
(B) The issuer exercising call options to refinance debt at lower prevailing market rates
(C) The decreased likelihood of the issuer calling the bonds as market interest rates decline
(D) The sharp decrease in the intrinsic market value of collateral assets securing the bond

May/June 2005

6. Which of the following is the most accurate interpretation of a bond portfolio's duration?

(A) It is the simple arithmetic average of the maturities of all individual bonds in the portfolio
(B) It is the weighted average of individual durations based on the proportion of capital invested
(C) It is the sum of the modified durations of each bond multiplied by their respective yields
(D) It is a measure solely of the reinvestment risk inherent across the combined bond holdings

Oct/Nov 2019

7. Which of the following accurately defines the Price Value of a Basis Point (PVBP)?
(A) The absolute value of the change in the price of a bond for a one percent change in the yield
(B) The absolute value of the change in the price of a bond for a one basis point change in the yield
(C) The percentage change in the price of a bond for a one basis point change in the yield
(D) The percentage change in the price of a bond for a one percent change in the yield

May/June 2011

8. Which of the following correctly describes a limitation of the PVBP approach?
(A) It assumes that the yield curve always moves in a non-parallel, steepening manner
(B) It may quantify the PVBP, but cannot predict the magnitude of day-to-day yield curve movements
(C) It cannot be applied to financial instruments that have known or definite cash flows
(D) It requires complex mathematical models that are counter-intuitive to most market practitioners

Oct/Nov 2022

9. All of the following types of fixed-income instruments typically display positive convexity EXCEPT:
(A) Plain vanilla bonds
(B) Mortgage-backed securities
(C) Non-callable corporate bonds
(D) Standard zero-coupon bonds

May/June 2017

10. If the PVBP of a 5-year bond with a face value of INR 100 is computed as 0.0426, how is this interpreted?
(A) For every basis point change in the yield, the price of the bond changes by INR 0.0426 in the same direction
(B) For every percent change in the yield, the price of the bond changes by INR 0.0426 in the opposite direction
(C) For every basis point change in the yield, the price of the bond changes by INR 0.0426 in the opposite direction
(D) For every basis point change in the yield, the yield of the bond changes by 0.0426%

Oct/Nov 2008

11. Arrange the following steps chronologically to compute Macaulay Duration:
I Multiply the present value of each cash flow with its timing.
II Compute the present value of periodic cash flows to determine the current price of the bond.
III Aggregate the products of present value and timing, and divide it by the bond's price.
IV Calculate the periodic future cash flows.
(A) (IV), (II), (I), (III)
(B) (II), (IV), (I), (III)
(C) (IV), (I), (II), (III)
(D) (I), (II), (III), (IV)

May/June 2020

12. Who first described the concept of duration in 1938?
(A) Harry Markowitz
(B) John Maynard Keynes
(C) Frederick Macaulay
(D) Eugene Fama

Oct/Nov 2014

13. Which of the following statements regarding the properties of duration is INCORRECT?
(A) Low coupon bonds possess lower durations than high coupon bonds of the same maturity
(B) Macaulay's duration of a coupon-paying bond remains strictly less than its term to maturity
(C) The duration of a zero-coupon bond is mathematically equal to its full contractual term to maturity
(D) For virtually all traded bonds, it is safe to assume that duration increases with maturity

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May/June 2009

14. Which of the following statements correctly describes a property of duration?
(A) The duration of a zero-coupon bond is always less than its term to maturity
(B) Holding other factors constant, a bond with a higher coupon rate has a higher duration than a bond with a lower coupon

43. (B) Bond C, because sensitivity is inversely related to the initial yield to maturity of the bond.
The sensitivity of a bond's price to interest rate changes is inversely related to its initial yield to maturity. This means that a bond currently selling at a higher yield, like Bond C at 10%, will exhibit less price volatility for a given change in rates compared to a similar bond selling at a lower yield, like Bond D at 6%.

44. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The capital gain from a decrease in interest rates is typically larger than the capital loss from an equivalent increase in rates for option-free bonds. This phenomenon is a direct result of the convex shape of the price-yield curve. Convexity ensures that bond prices rise faster when yields drop than they fall when yields rise, benefiting the long-term bondholder.

45. (A) P-3, Q-2, R-4, S-1
Zero-coupon bonds are issued at a discount and pay only at maturity. Floating Rate Bonds have coupons that reset periodically based on a benchmark. Bonds with call or put options allow for early redemption by either the issuer or the holder. Finally, Fixed Rate Bonds are the most traditional form, where the interest rate remains unchanged throughout the security's term.

46. (B) (I), (II), and (IV)
To accurately determine the market price of an option-free bond, an analyst must first identify all future cash flows, including interest and principal. Second, they must determine the appropriate discount rate based on market yields and risk. Finally, they calculate the present value of those estimated cash flows. Finding the future value or subtracting par is not part of pricing.

47. (B) Zero coupon bonds are issued at a premium and redeemed at a discount on maturity.
Zero-coupon bonds are never issued at a premium; they are fundamentally designed to be issued at a discount to their face value. The return for the investor is the difference between this low initial price and the full par value received at maturity. Stating they are issued at a premium and redeemed at a discount reverses the basic financial logic.

48. (D) (I), (II), (III), and (IV)
Four fundamental properties govern bond pricing: prices move inversely to yields; bonds trade at par when the coupon equals the yield; they trade at a discount when the coupon is lower than the yield; and they trade at a premium when the coupon is higher than the yield. All these statements are correct and describe the essential relationships in the fixed-income market.

49. (A) It is multiplied by 2.
To maintain consistency with standard semi-annual coupon-paying bonds, the pricing of zero-coupon bonds often uses semi-annual compounding periods. When calculating the number of periods for discounting, the total number of years to maturity is multiplied by two. This adjustment ensures that the yield to maturity is comparable across different types of bonds regardless of their actual payment frequency.

50. (C) Bond B, because higher discount rates apply to cash flows occurring further in the future.
Long-term bonds are more sensitive to interest rate changes because their cash flows occur further in the future. When market rates rise, these distant payments are discounted more heavily over more periods, leading to a larger percentage drop in current price. Therefore, Bond B, with its 30-year maturity, will experience a much more significant decline than the 5-year Bond A.

51. (D) (I), (II), (III), (IV), and (V)
The fixed income market encompasses a wide range of debt instruments issued by diverse entities. This includes Treasury Bills from the central government, debentures from corporations, and State Development Loans from regional governments. Additionally, special securities from government agencies and sovereign gold bonds issued on behalf of the state also constitute valid exposures to the broader fixed income and debt markets.

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bond at the initial yield.
(A) (I), (II), (III)
(B) (III), (I), (II)
(C) (II), (III), (I)
(D) (III), (II), (I)

May/June 2014

22. In terms of percentage, what does one basis point represent?
(A) 1%
(B) 0.1%
(C) 0.01%
(D) 0.001%

Oct/Nov 2016

23. What is the fundamental outcome of a perfect hedge on a bond position?
(A) It eliminates downside risk while allowing for substantial upside capital gain
(B) It maximizes the net profit by leveraging the primary bond's duration
(C) It increases the portfolio's effective maturity to capture long-term market trends
(D) It results in a zero profit-and-loss position each day by matching cash flows

May/June 2021

24. All of the following steps are required in computing the Macaulay Duration of a bond EXCEPT:
(A) Accurately calculating the timing and amount of all periodic future cash flows
(B) Computing the present value of the cash flows to find the current price of the bond
(C) Aggregating the products of present value and timing, and dividing by the bond's price
(D) Multiplying each cash flow's present value by the square of its timing period

Oct/Nov 2006

25. Which of the following statements about the computation of Portfolio PVBP is INCORRECT?
(A) The portfolio PVBP can be computed easily due to the additive properties of individual PVBPs
(B) Portfolio PVBP is the weighted average of the PVBPs of individual securities
(C) It involves multiplying the individual PVBP/100 by the market value of each respective security
(D) The products of PVBP/100 and market values are aggregated to find the portfolio PVBP

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May/June 2019

26. Which of the following defines Macaulay duration of a debt security?
(A) The straight-line average of the time to receipt of all promised cash flows multiplied by the price of the security
(B) The sum of the present values of future cash flows divided by the total number of periods to maturity
(C) The percentage change in the price of a bond divided by the percentage change in the yield
(D) The discounted-cash-flow-weighted time to receipt of all its promised cash flows divided by the price of the security

Oct/Nov 2011

27. Which is the best explanation for why the duration approximation (the straight line) always understates the value of a plain vanilla bond when yields change?
(A) It underestimates price gains when yields fall and overestimates price declines when yields rise
(B) It fails to account for the reinvestment rate of intermediate coupon payments over the bond's life
(C) It is a first-order approximation that assumes zero volatility in the underlying yield curve
(D) It focuses exclusively on the final principal repayment while ignoring all interim cash flows

May/June 2007

28. Why is the second approximation of the percentage price change of a bond referred to as "convexity"?
(A) Because it measures the amount of 'whip' due to the convex shape of the bond's price yield curve
(B) Because it perfectly aligns with the linear relationship between bond prices and yields
(C) Because it represents the convergence of yield paths to a singular convex point at maturity

61. (B) (II) and (III) only
There is an inverse relationship between a bond's coupon rate and its interest rate risk. Prices of low-coupon bonds are significantly more sensitive to yield changes because a higher proportion of their value is tied to the final principal payment. Conversely, high-coupon bonds are less sensitive. Therefore, stating that risk is directly related to the coupon rate is factually incorrect.

62. (A) They provide a simple way for entities to raise capital and offer investors a low-risk alternative to stocks.
Fixed-income securities are the most common way for governments and corporations to raise capital because they offer a structured and predictable borrowing mechanism. For investors, these instruments provide a lower-risk alternative to equity, focusing on income generation and principal protection. This balance of interests makes the debt market the largest segment of the global financial system by total value.

63. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Financial markets operate on a fundamental trade-off between safety, liquidity, and yield. Highly liquid and safe assets generally offer lower returns to investors. Risk managers must navigate this interplay by using market intelligence to find an optimal mix of securities that maximizes yield while maintaining acceptable levels of risk and liquidity for the institution's overall financial stability and objectives.

64. (D) (I), (II), (III), (IV), and (V)
Pricing an option-free coupon bond requires five essential pieces of information. The face value and coupon payments define the cash flows, while the maturity date sets the timeline. The Yield to Maturity serves as the discount rate, and the compounding frequency determines how often interest is calculated. All these variables are necessary to solve the standard present value formula accurately.

65. (B) Interest rate risk is directly and exactly proportional to bond maturity.
While it is true that longer maturity generally leads to higher interest rate sensitivity, the relationship is not exactly proportional. The sensitivity increases as maturity grows, but it does so at a decreasing rate. For example, a 20-year bond is more sensitive than a 10-year bond, but it does not possess exactly double the interest rate risk or price volatility.

66. (D) Mortgage-backed security
In the context of the basic fixed-income instruments and government securities discussed, mortgage-backed securities are considered complex structured products or asset-backed securities rather than standard bond types like floating rate, capital indexed, or gold bonds. While they are debt-related, they represent a different asset class involving the securitization of specific underlying loan pools rather than direct sovereign or corporate debt.

67. (A) (I), (II), and (III) only
The percentage price sensitivity of a bond, often measured by duration, is determined by three primary factors: the time remaining until maturity, the stated coupon rate, and the current yield to maturity. While the face value determines the absolute currency amount of the price, it does not influence the percentage sensitivity or volatility of the bond's price to interest rate movements.

68. (A) Only (I)
For an option-free bond, the relationship between price and par value is determined by comparing the coupon rate to the required yield. When these two are equal, the bond trades at par. However, when the coupon rate is higher than the yield, the bond trades at a premium, meaning its price is more than its par value, not less.

69. (B) Bonds are a major component of the investment portfolio, including exposure to the trading book.
For most banks, fixed income securities, particularly government bonds, form a substantial portion of their total investment portfolio. These holdings are managed across different categories, including the trading book

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an investor to fully capture any upside gain if market interest rates move favorably.
Reason (R): A perfect hedge is intended to protect against loss by matching the cash flows on account of interest to maintain a zero profit-and-loss position.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2017

35. Consider the following statements regarding Target Date Immunization:
I It ensures that a stream of fixed outflows can be met from available assets.
II It is achieved by holding a portfolio of fixed income assets with the same current value and modified duration as the liability stream.
Which of the above statement(s) is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2015

36. Based on the scenario provided, answer the following question:
A trader holds a long position of INR 10,000,000 (nominal value) in a 15-year bond. The PVBP of this primary bond is estimated at 0.0954. To protect the position against rising interest rates, the trader decides to hedge using a 5-year zero-coupon bond as the hedging instrument, which has a PVBP of 0.0318. Assume the yield beta is 1.
If the market yield increases by 15 basis points, what is the approximate expected monetary loss on the primary long bond position alone (ignoring the hedge)?
(A) INR 143,100
(B) INR 9,540
(C) INR 1,431,000
(D) INR 47,700

Oct/Nov 2020

37. Match the concepts in List I with their descriptions in List II.
List I: (Concepts)
P. PVBP
Q. Modified Duration
R. Convexity
S. Effective Duration
List II: (Descriptions)
1. A measure of the amount of 'whip' in the bond's price yield curve
2. Used to calculate the price sensitivity of bonds with embedded options
3. Macaulay's duration divided by 1 plus the prevailing interest rate
4. Absolute value of the change in the price of a bond for a one basis point change in the yield
(A) P-4, Q-3, R-1, S-2
(B) P-3, Q-4, R-2, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-1, Q-2, R-4, S-3

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May/June 2018

38. Consider the following statements regarding Convexity:
I Convexity is the first derivative of modified duration with respect to yield.
II Convexity is a measure of the amount of 'whip' in the bond's price yield curve.
III If convexity is negative, rate moves in either direction reduce returns.
IV Positive convexity decreases return so long as interest rates move.
Which of the above statement(s) is/are correct?
(A) (II), (III), and (IV) are correct
(B) (I), (III), and (IV) are correct
(C) All statements are correct
(D) (I), (II), and (III) are correct

Oct/Nov 2013

39. The following questions consist of two statements — Assertion (A) and Reason (R). Answer these questions selecting the appropriate option.
Assertion (A): The estimation of a bond's price change for a large shift in yield is significantly improved by using a second approximation called convexity.

Consider a callable bond with a current market value (V0) of INR 102.50. Risk managers project a yield change (Δy) of 100 basis points (0.01). If the yield increases by 100 basis points, the bond price is estimated to be INR 100.10 (V+). If the yield decreases by 100 basis points, the bond price is estimated to be INR 105.30 (V-).

Using the computed Effective Duration and Effective Convexity, what is the approximate percentage price change given a 100 basis point (0.01) rise in interest rates? (Use formula: Change = (– Effective Duration × Δy) + (0.5 × Effective Convexity × Δy^2)

(A) –2.6342%
(B) –4.8781%
(C) –2.4390%
(D) –1.9827%

May/June 2025

62. Based on the bond data provided, answer the following question:

A bank has invested in a bond with a current market price of INR 950.00. The Macaulay duration of the bond has been computed as 4.1600 years. The prevailing yield to maturity for the bond is 4.00% per half year (an 8% annual required yield, semiannually compounded).

Based on the Modified Duration calculated, if the yield increases by 50 basis points (0.50%), what is the expected percentage change in the price of the bond?

(A) Decrease by 2.000%
(B) Decrease by 4.000%
(C) Increase by 2.000%
(D) Decrease by 0.500%

Oct/Nov 2005

63. Based on the portfolio details provided, answer the following question:

A dealer holds the following two-bond portfolio:
Bond X: Market Value INR 4,000,000; PVBP = 0.0525
Bond Y: Market Value INR 6,000,000; PVBP = 0.1250

If the dealer expects interest rates to rise significantly, what action should the dealer take regarding the Portfolio PVBP to manage risk?

(A) Increase the overall PVBP of the portfolio
(B) Keep the PVBP strictly neutral regardless of the rate expectation
(C) Reduce the overall PVBP of the portfolio
(D) Shift all investments into higher PVBP bonds

May/June 2014

64. Read the following scenario and answer the question that follows:

A bank faces a future obligation to pay a guaranteed lump sum of INR 2,000 exactly 4 years from today. The current annual compound interest rate is 6%. To immunize the portfolio, the bank invests in a coupon bond that has a calculated Macaulay duration of exactly 4 years, ensuring that its cash flows (coupons and principal) will compound and mature to meet the obligation.

If the market interest rate drops suddenly to 5% immediately after purchasing the bond and stays there, how do reinvestment risk and price risk interact to maintain the target value of INR 2,000?

(A) Reinvestment income increases, but the market price of the bond decreases, balancing each other
(B) Both reinvestment income and the market price of the bond decrease proportionately
(C) Reinvestment income decreases, but the market price of the bond when sold increases, balancing each other
(D) The drop in interest rate invalidates the immunization, causing a shortfall

Oct/Nov 2016

65. Based on the callable bond information provided, answer the following question:

Consider a callable bond with a current market value (V0) of INR 102.50. Risk managers project a yield change (Δy) of 100 basis points (0.01). If the yield increases by 100 basis points, the bond price is estimated to be INR 100.10 (V+). If the yield decreases by 100 basis points, the bond price is estimated to be INR 105.30 (V-).

What is the Effective Duration of the callable bond?

(A) 2.0315
(B) 2.5366
(C) 5.0732
(D) 3.1500

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of this primary bond is estimated at 0.0954. To protect the position against rising interest rates, the trader decides to hedge using a 5-year zero-coupon bond as the hedging instrument, which has a PVBP of 0.0318. Assume the yield beta is 1.

What nominal value of the 5-year zero-coupon hedging bond must be sold short to fully hedge the primary bond position?

(A) INR 3,333,333
(B) INR 10,000,000
(C) INR 30,000,000
(D) INR 9,540,000

May/June 2024

46. Match the specific conditions in List I with their impact on duration in List II.

List I: (Conditions)

P. Higher coupon rate
Q. Lower yield to maturity
R. Zero-coupon bond
S. Longer term to maturity (generally)

List II: (Impacts)

1. Causes a lower duration relative to a lower coupon
2. Results in a higher duration compared to a higher yield
3. Has a duration exactly equal to its term to maturity
4. Generally results in a higher duration compared to a shorter term

(A) P-1, Q-2, R-3, S-4
(B) P-2, Q-1, R-4, S-3
(C) P-1, Q-3, R-2, S-4
(D) P-3, Q-4, R-1, S-2

Oct/Nov 2007

47. The following questions consist of two statements — Assertion (A) and Reason (R). Answer these questions selecting the appropriate option.

Assertion (A): Mortgage-backed securities often exhibit negative convexity in a falling interest rate environment.

Reason (R): As interest rates fall, mortgage borrowers are expected to refinance their loans into lower rates, meaning the investor receives money back faster than anticipated.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2005

48. Which of the following pairs linking a risk term to its conceptual definition is INCORRECTLY matched?

(A) Reinvestment Risk — Uncertainty about yields prevailing at the time of interim cash flows
(B) Immunization — Strategy that strictly maximizes yield curve upside while absorbing downside losses
(C) Liquidation Risk — Uncertainty about the price at which a bond will sell prior to maturity
(D) Yield Changes — Can cause unexpected bond price changes affecting reinvestment and liquidation

Oct/Nov 2019

49. Consider the following statements about hedging using basis point value:

I A perfect hedge should result in a zero profit-and-loss position each day.
II A hedge is intended to protect against loss and also drastically improves the profit outlook of a position.
III Hedging a long position in a 10-year bond requires a short position in a similar bond.
IV The intention of hedging is to match the cash flows on account of interest so the principle remains intact.
V The hedge ratio is calculated as the PVBP of the primary bond divided by the PVBP of the hedging instrument.

Which of the above statement(s) is/are correct?

(A) (I), (III), (IV), and (V)
(B) (I), (II), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (III), and (V)

May/June 2011

50. Consider the following statements regarding bond price volatility:

I The percentage price change is exactly the

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same for all bonds when required yield changes.

II For small changes in required yield (up to 10 basis points), the percentage price change is roughly the same whether yield increases or decreases.

III For a large change in required yield, the percentage price increase is greater than the percentage price decrease.

Which of the above statement(s) is/are correct?

(A) (I), (II) and (III) are correct
(B) (I) and (III) are correct
(C) (II) and (III) are correct
(D) All statements are correct

Oct/Nov 2022

51. Based on the portfolio details provided, answer the following question:

A dealer holds the following two-bond portfolio: Bond X: Market Value INR 4,000,000; PVBP = 0.0525

Bond Y: Market Value INR 6,000,000; PVBP = 0.1250

What is the Portfolio PVBP for the given holdings?

(A) INR 2,100
(B) INR 7,500
(C) INR 11,500
(D) INR 9,600

May/June 2017

52. Which of the following is the correctly matched pair regarding the properties of duration?

(A) The Modified duration of a zero-coupon bond is exactly equal to its term to maturity
(B) If maturity is held constant, a bond with a higher coupon rate has a higher duration
(C) Holding other factors constant, the duration of a coupon bond is lower when the bond's yield is lower
(D) For bonds selling at high discount, duration may decrease with increasing maturity

Oct/Nov 2008

53. Consider the following statements regarding convexity:

I A bond with positive convexity will gain more in price when yields fall than it will lose when yields rise by the same amount.

II Mortgage-backed securities often exhibit negative convexity because borrowers refinance loans into lower rates when interest rates fall.

Which of the above statement(s) is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2020

54. The following questions consist of two statements — Assertion (A) and Reason (R). Answer these questions selecting the appropriate option.

Assertion (A): Macaulay's duration of a coupon bond is always less than its term to maturity.

Reason (R): Early coupon payments are given weight in calculating the weighted-average maturity of a bond's payments, thereby reducing the effective maturity.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2014

55. Consider the following statements regarding Bond Portfolio Management:

I Bank liabilities are primarily long-term deposits with high duration.

II Reinvestment risk arises due to uncertainty about interim reinvestment rates.

III Liquidation risk involves the uncertainty about the price at which an instrument can be sold prior to maturity.

IV Matching the interest rate exposure of assets and liabilities is a core immunization technique.

Which of the above statement(s) is/are correct?

(A) (II), (III), and (IV) are correct
(B) (I), (II), and (III) are correct
(C) (I), (III), and (IV) are correct

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(D) (I), (II), and (IV) are correct

May/June 2009

56. Match the interest rate risk components in List I with their characteristics in List II.

List I: (Risk Components)

P. Reinvestment Risk
Q. Liquidation Risk
R. Target Date Immunization
S. Interest Rate Risk (General)

List II: (Characteristics)

1. Affects the net worth of the firm or ability to meet obligations
2. Uncertainty about what yields will prevail at the time of an interim cash flow
3. Uncertainty about the price at which a bond can be sold at a future date
4. Achieved by holding a portfolio with the same current value and modified duration as the liability stream

(A) P-2, Q-3, R-4, S-1
(B) P-3, Q-2, R-1, S-4
(C) P-2, Q-4, R-3, S-1
(D) P-1, Q-2, R-4, S-3

Oct/Nov 2025

57. Based on the scenario provided, answer the following question:

A trader holds a long position of INR 10,000,000 (nominal value) in a 15-year bond. The PVBP of this primary bond is estimated at 0.0954. To protect the position against rising interest rates, the trader decides to hedge using a 5-year zero-coupon bond as the hedging instrument, which has a PVBP of 0.0318. Assume the yield beta is 1.

What is the calculated hedge ratio for this position?

(A) 3.0000
(B) 0.3333
(C) 0.0030
(D) 0.1272

May/June 2013

58. Consider the following statements:

I Effective duration and convexity provide accurate calculations of price sensitivity for bonds with embedded options.
II Modified duration and convexity allow for cash flows to change due to a change in yield.

Which of the above statement(s) is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2018

59. Consider the following statements on Convexity and risk management:

I The duration approximation always overstates the value of the bond due to the true price-yield curvature.
II A very positively convex security implies being long volatility.
III Matching convexity sets the initial change in interest rate sensitivity of assets equal to that of liabilities.
IV Effective duration calculations provide a precise absolute price change rather than an approximation.
V Modified duration assumes cash flows remain unchanged despite shifts in yield.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (IV)
(B) (II), (IV), and (V)
(C) (II), (III), and (V)
(D) (I), (III), and (IV)

May/June 2006

60. Consider the following statements about the PVBP approach:

I PVBP measures the absolute value of the change in the price of a bond for a one basis point change in the yield.
II An advantage of PVBP is that it can amalgamate all cash flows from a portfolio of transactions to calculate portfolio PVBP.
III A major advantage of PVBP is that it accurately predicts the non-parallel shifts in the yield curve on a day-to-day basis.

Which of the above statement(s) is/are correct?

(A) (II) and (III) are correct
(B) (I) and (II) are correct
(C) (I) and (III) are correct
(D) All statements are correct

Oct/Nov 2010

61. Based on the callable bond information provided, answer the following question:

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Reason (R): Modified duration is only a first (linear) approximation of the percentage price change, which becomes less accurate for larger yield changes due to the curved shape of the price-yield relationship.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2008

40. Which of the following pairs linking a formula component to its description is INCORRECTLY matched?

(A) PVBPp — Price Value of a Basis Point of a Portfolio
(B) wi — Proportion of the portfolio invested in security i
(C) CPt — Periodic cash flow
(D) Ni — Number of days to maturity of Security i

Oct/Nov 2021

41. Based on the portfolio details provided, answer the following question:

A dealer holds the following two-bond portfolio: Bond X: Market Value INR 4,000,000; PVBP = 0.0525

Bond Y: Market Value INR 6,000,000; PVBP = 0.1250

If the yield across the portfolio increases by 8 basis points, what is the approximate financial loss for the entire portfolio?

(A) INR 9,600
(B) INR 76,800
(C) INR 16,800
(D) INR 60,000

May/June 2022

42. Match the formulas in List I to their correct identifiers in List II.

List I: (Formulas)
P. Σ wi Di
Q. PVBPp / PVBPh
R. D / (1 + y/2)
S. $(V_- - V_+) / (2\ V_0 \times \Delta y)$

List II: (Identifiers)
1. Modified Duration
2. Effective Duration
3. Portfolio Duration
4. Hedge Ratio

(A) P-3, Q-4, R-1, S-2
(B) P-4, Q-3, R-2, S-1
(C) P-3, Q-1, R-4, S-2
(D) P-2, Q-4, R-1, S-3

Oct/Nov 2023

43. Consider the following steps involved in computing duration:

I Multiply present value of each cash flow with its timing.
II Divide the aggregated products of PV and timing by the bond's maturity in years.
III Calculate periodic future cash flows.
IV Compute the present value of these cash flows to determine the current bond price.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) All statements represent valid steps

May/June 2012

44. Consider the following statements regarding the properties of duration:

I Macaulay's duration is always less than the bond's term to maturity for a coupon bond.
II A bond with a higher coupon rate has a lower duration than a bond with a lower coupon rate, assuming maturity is constant.
III Duration always strictly increases with maturity for bonds selling at a high discount.

Which of the above statement(s) is/are correct?

(A) (I) and (II) are correct
(B) (II) and (III) are correct
(C) (I) and (III) are correct
(D) All statements are correct

Oct/Nov 2015

45. Based on the scenario provided, answer the following question:

A trader holds a long position of INR 10,000,000 (nominal value) in a 15-year bond. The PVBP

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May/June 2021

66. Based on the bond data provided, answer the following question:

A bank has invested in a bond with a current market price of INR 950.00. The Macaulay duration of the bond has been computed as 4.1600 years. The prevailing yield to maturity for the bond is 4.00% per half year (an 8% annual required yield, semiannually compounded).

What is the Modified Duration of the bond?

(A) 4.3264
(B) 3.8518
(C) 3.9920
(D) 4.0000

Oct/Nov 2006

67. Read the following scenario and answer the question that follows:

A bank faces a future obligation to pay a guaranteed lump sum of INR 2,000 exactly 4 years from today. The current annual compound interest rate is 6%. To immunize the portfolio, the bank invests in a coupon bond that has a calculated Macaulay duration of exactly 4 years, ensuring that its cash flows (coupons and principal) will compound and mature to meet the obligation.

If the market interest rate stays perfectly flat at 6% for the entire 4-year period, what happens to the accumulated value of the investment?

(A) It falls short of INR 2,000 because coupons are reinvested at a flat rate
(B) It exceeds INR 2,000 due to the positive convexity of the bond
(C) It varies depending solely on the specific coupon rate of the chosen bond
(D) It precisely equals the target value of INR 2,000 needed to meet the obligation

May/June 2019

68. Based on the callable bond information provided, answer the following question:

Consider a callable bond with a current market value (V0) of INR 102.50. Risk managers project a yield change (Δy) of 100 basis points (0.01). If the yield increases by 100 basis points, the bond price is estimated to be INR 100.10 (V+). If the yield decreases by 100 basis points, the bond price is estimated to be INR 105.30 (V-).

What is the Effective Convexity of the callable bond?

(A) 19.512
(B) 38.048
(C) 9.756
(D) 24.240

Oct/Nov 2011

69. Based on the bond data provided, answer the following question:

A bank has invested in a bond with a current market price of INR 950.00. The Macaulay duration of the bond has been computed as 4.1600 years. The prevailing yield to maturity for the bond is 4.00% per half year (an 8% annual required yield, semiannually compounded).

Based on the percentage change computed above, what will be the absolute change in the bond's price?

(A) INR 38.00
(B) INR 19.00
(C) INR 4.75
(D) INR 40.00

May/June 2007

70. Read the following scenario and answer the question that follows:

A bank faces a future obligation to pay a guaranteed lump sum of INR 2,000 exactly 4 years from today. The current annual compound interest rate is 6%. To immunize the portfolio, the bank invests in a coupon bond that has a calculated Macaulay duration of exactly 4 years, ensuring that its cash flows (coupons and principal) will compound and mature to meet the obligation.

In the scenario described above, matching the duration of the asset (the bond) to the duration of the liability (4 years) is an application of which specific risk management strategy?

(A) Contingent Immunization
(B) Target Date Immunization
(C) Convexity Hedging
(D) Cash Flow Matching (Dedication)

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ANSWERS

1. (D) The yield curve moves up or down in a parallel manner
PVBP represents the absolute change in price for a single basis point shift in yield. This metric operates under the specific assumption that the entire yield curve moves in a parallel fashion across all maturities. By calculating the value impact of minor yield changes, it helps managers estimate exposure to interest rate risks effectively in fixed-income portfolios.

2. (C) Modified duration is the second derivative of price with respect to yield
The statement concerning modified duration is inaccurate because modified duration represents the first derivative of the bond's price with respect to its yield. Convexity, however, is the second derivative, measuring the rate of change of duration itself. Plain vanilla bonds usually show positive convexity, which enhances gains as interest rates shift significantly in either direction in the market.

3. (C) A portfolio that remains unaffected by interest rate changes
An immunized portfolio is strategically designed to ensure that the total value of its assets remains relatively stable despite fluctuations in interest rates. By balancing reinvestment risk and price risk, managers create a position that protects against market volatility. This strategy is essential for institutions needing to meet specific future financial obligations regardless of how market yields evolve.

4. (C) To match the price change of the primary instrument with that of the hedging instrument
When hedging bond positions using Basis Point Values, the core objective is to ensure that the price movement of the primary asset is offset by the hedging instrument. This requires calculating a hedge ratio that aligns the sensitivities of both positions. The ultimate goal is to achieve a neutral exposure, minimizing potential financial losses resulting from adverse interest rate shifts.

5. (B) The issuer exercising call options to refinance debt at lower prevailing market rates
Callable bonds experience negative convexity when interest rates drop because issuers are likely to refinance their debt. This exercise of the call option limits the bond's price appreciation compared to non-callable securities. As market rates fall, the potential for early redemption prevents the bond price from rising as much as a standard bond would under similar economic conditions.

6. (B) It is the weighted average of individual durations based on the proportion of capital invested
The duration of a bond portfolio represents the weighted average of the durations of each individual security held. This calculation uses the proportion of the total capital invested in each bond as the weighting factor. It provides a consolidated measure of the portfolio's sensitivity to interest rate changes, allowing managers to assess overall risk exposure across various fixed-income assets.

7. (B) The absolute value of the change in the price of a bond for a one basis point change in the yield
Price Value of a Basis Point is defined as the absolute change in a bond's price resulting from a one basis point change in yield. This metric is a vital tool for traders to quantify price sensitivity in monetary terms. It allows for a simple assessment of interest rate risk by showing exactly how much value is at stake.

8. (B) It may quantify the PVBP, but cannot predict the magnitude of day-to-day yield curve movements
A significant limitation of the PVBP approach is its inability to forecast the actual magnitude or frequency of yield curve movements. While it quantifies the impact of a single basis point shift, it does not provide insight into market volatility or directional trends. Consequently, practitioners must combine this measure with

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other analytical tools to manage broader market risks effectively.

9. (B) Mortgage-backed securities
Mortgage-backed securities are unique because they often display negative convexity rather than the positive convexity found in plain vanilla or zero-coupon bonds. This phenomenon occurs due to prepayment risk, where homeowners refinance their mortgages as interest rates decline. This behavior limits the price appreciation of the security, distinguishing it from standard fixed-income instruments that typically benefit from falling rates.

10. (C) For every basis point change in the yield, the price of the bond changes by INR 0.0426 in the opposite direction
A PVBP of 0.0426 indicates that for every one basis point shift in the required yield, the price of the bond will change by INR 0.0426. Because bond prices and yields move inversely, an increase in yield results in a price decrease, while a yield reduction leads to a price increase. This measure helps quantify interest rate risk.

11. (A) (IV), (II), (I), (III)
Computing Macaulay Duration involves several sequential steps starting with the determination of all future periodic cash flows. After calculating these amounts, the present value of each flow is found to establish the bond's price. Each present value is then multiplied by its respective timing before the aggregated products are divided by the total price to find the weighted-average maturity.

12. (C) Frederick Macaulay
Frederick Macaulay is credited with introducing the concept of duration in 1938 as a measure of the weighted-average time until cash flows are received. This fundamental metric revolutionized bond analysis by providing a way to quantify interest rate sensitivity beyond simple maturity. It remains a cornerstone of fixed-income portfolio management and risk assessment for financial professionals and academic researchers.

13. (A) Low coupon bonds possess lower durations than high coupon bonds of the same maturity
The property stating that low coupon bonds have lower durations than high coupon bonds is incorrect. In reality, lower coupon rates result in higher durations for a given maturity because a greater proportion of the bond's total value is concentrated in the final principal payment. Higher coupons accelerate the receipt of cash flows, thereby reducing the weighted-average timing of payments.

14. (C) For bonds selling at a high discount, duration may decrease with increasing maturity
For bonds trading at a deep discount, the relationship between maturity and duration can become non-monotonic, where duration might actually decrease as maturity increases. This rare occurrence happens because the present value of distant payments becomes negligible at very high discount rates. While duration generally increases with maturity for most bonds, these specific market conditions create an interesting mathematical exception.

15. (D) The uncertainty about the price at which a bond can be sold prior to maturity at a specific time
Liquidation risk refers to the uncertainty surrounding the specific price an investor will receive when selling a bond before its scheduled maturity date. Since market conditions fluctuate, the value at the time of sale may differ significantly from the purchase price or the par value. This form of risk is particularly relevant for investors who may need immediate liquidity.

16. (A) The uncertainty about what yields will prevail at the time of an interim cash flow
Reinvestment risk occurs when the cash flows received from a bond, such as periodic coupon payments, must be reinvested at lower prevailing market interest rates. This uncertainty affects the total realized return of the investment over its holding period. It is particularly significant in a declining interest rate environment where new investment opportunities offer less yield than the original bond.

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17. (A) Given a specific coupon, a bond with a shorter maturity generally has a higher duration
The statement that shorter maturity bonds possess higher duration is incorrect because duration generally increases with the term to maturity. A longer-term bond has cash flows further in the future, which makes its present value more sensitive to interest rate changes. Conversely, shorter-term bonds return capital more quickly, resulting in lower duration and reduced price sensitivity to yield shifts.

18. (A) MD = D / (1 + y/2)
Modified duration is calculated by adjusting the Macaulay duration by the periodic yield of the bond. For semi-annual compounding, the formula divides the duration by one plus half of the annual yield. This adjustment reflects the percentage change in price for a unit change in yield, providing a more direct measure of sensitivity for practitioners analyzing fixed-income securities' volatility.

19. (D) Target date immunization ensures a stream of fixed outflows can be met from available liabilities
Target date immunization is a strategy designed to ensure that assets grow to a value sufficient to cover a future stream of outflows. The incorrect statement suggests this is met from available liabilities, when in fact, the assets are managed to match the liability stream. This process involves matching the duration and value of assets to specific future payment obligations.

20. (A) It sets the initial change in interest rate sensitivity of the assets equal to that of the liabilities
Matching both duration and convexity between assets and liabilities is a sophisticated risk management technique. This approach ensures that the initial interest rate sensitivity of the assets is perfectly aligned with that of the liabilities. By accounting for the curvature of the price-yield relationship, managers can achieve a more stable net worth even when interest rates experience significant market movements.

21. (B) (III), (I), (II)
Calculating the PVBP of a bond requires a specific three-step sequence to ensure accuracy. First, the current price is determined based on the initial yield. Next, the yield is adjusted by exactly one basis point to calculate a new price. Finally, the difference between these two prices is found to identify the absolute monetary change per basis point movement.

22. (C) 0.01%
One basis point is a standard unit of measure in financial markets representing one one-hundredth of a percentage point. In decimal form, this is equivalent to zero point zero zero zero one, or zero point zero one percent. This small unit allows for precise communication regarding interest rate changes, yield fluctuations, and the pricing of various fixed-income financial instruments.

23. (D) It results in a zero profit-and-loss position each day by matching cash flows
A perfect hedge aims to eliminate the impact of price fluctuations by ensuring that gains in one position are exactly offset by losses in another. This results in a zero profit-and-loss situation regardless of market movements. By matching the sensitivities of the primary and hedging instruments, investors protect their capital from the volatility associated with unexpected shifts in interest rates.

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24. (D) Multiplying each cash flow's present value by the square of its timing period
Calculating Macaulay duration involves determining future cash flows, finding their present values, and weighting them by timing. Multiplying each present value by the square of its timing period is not part of this process; rather, that specific step is used in the calculation of convexity. Duration focuses on the first-order linear relationship between bond prices and interest rate movements.

25. (B) Portfolio PVBP is the weighted average of the PVBPs of individual securities
Portfolio PVBP is calculated by aggregating the individual PVBP contributions of each security, adjusted for their market value. The claim that it is a simple weighted average of individual PVBPs is incorrect because the calculation involves multiplying the PVBP per unit by the total market value. This additive property makes it a straightforward tool for assessing overall interest rate risk.

26. (D) The discounted-cash-flow-weighted time to receipt of all its promised cash flows divided by the price of the security
Macaulay duration is defined as the weighted-average time to receive the cash flows from a debt security, where the weights are the present values of those cash flows. By dividing this sum by the bond's current market price, analysts determine the effective maturity of the instrument. It serves as a key indicator of a bond's sensitivity to interest rate shifts.

27. (A) It underestimates price gains when yields fall and overestimates price declines when yields rise
The linear duration approximation understates the true value of a bond because it ignores the curved relationship between price and yield. Specifically, this straight-line estimate fails to capture the full price appreciation when yields decline and overestimates the price drop when yields rise. Accounting for convexity corrects this error, providing a more accurate reflection of the bond's market price.

28. (A) Because it measures the amount of 'whip' due to the convex shape of the bond's price yield curve
Convexity is often described as a measure of the 'whip' or curvature in the relationship between a bond's price and its yield. This term captures the second-order effect that duration, being a linear approximation, misses. By accounting for this curve, investors can more accurately estimate price changes during periods of high volatility, leading to better risk management and stability.

29. (C) It perfectly accounts for non-parallel shifts across the entire yield curve
While PVBP is a highly useful and widely accepted metric for measuring interest rate risk, it assumes that the yield curve shifts in a parallel manner. It does not perfectly account for non-parallel shifts, such as steepening or flattening of the curve. This limitation means managers must be cautious when applying PVBP to portfolios with diverse maturity profiles across different segments.

30. (D) For a given large change in basis points in the required yield, the percentage price increase is greater than the percentage price decrease
A key characteristic of bond price volatility is that for a large change in required yield, the percentage price increase when yields fall is greater than the percentage price decrease when yields rise by the same amount. This property is due to the convex shape of the price-yield curve, which benefits bondholders by providing asymmetric returns during large interest rate swings.

31. (C) For small changes in required yield, percentage price change is roughly the same whether yield increases or decreases
In bond pricing, small changes in the required yield lead to percentage price changes that are approximately equal in magnitude regardless of whether the yield increases or decreases. This symmetry exists because the price-yield curve is relatively linear over very short intervals. However, as the change in yield becomes larger, the effects of convexity cause price movements to become asymmetric.

32. (B) (I), (II), and (V)
Valid methods for measuring interest rate risk include sensitivity approaches and Value at Risk. The sensitivity approach specifically quantifies how bond prices react to unit changes in yield. Furthermore, duration acts as a reliable estimator for the volatility of a bond portfolio's market value. These combined tools allow financial institutions to monitor and manage their exposure to fluctuating interest rates effectively.

33. (A) P-3, Q-4, R-2, S-1
In the effective convexity formula, V+ represents the bond price when the yield is increased, while V- denotes the price when the yield is decreased. V0 is the initial market price per hundred of par value, and delta y represents the specific change in interest rate used for the calculation. Correctly identifying these variables is essential for measuring price curvature accurately.

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curve is short and wide.

Oct/Nov 2019

20. Which of the following considerations influence the choice of the confidence level in Value at Risk (VaR) calculations?

I The degree of risk aversion of the company.
II The cost of a loss exceeding VaR.
III The physical liquidation period of the longest-held asset class.
IV The institutional requirement to avoid the likelihood of bankruptcy to the maximum extent.

Which of the above statements are correct?

(A) (I), (II), and (IV)
(B) (I), (II), and (III)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

May/June 2009

21. What is the main benefit of the Historical Simulation (HS) method compared to the normal (parametric) method?

(A) It generates entirely random hypothetical scenarios to help project unforeseen and extreme future market movements.
(B) It is highly computationally efficient, particularly for managing large portfolios containing highly complex securities.
(C) It accommodates linear or non-linear portfolios without assuming a specific distribution of price changes.
(D) It completely eliminates the requirement for gathering and cleaning any historical market price or rate data.

Oct/Nov 2011

22. A bank's risk manager calculates the daily Value at Risk (VaR) for a trading portfolio at a 99% level of confidence and determines the value is ₹ 200,000.

On the following day, a sudden market swing occurs. Based on the concept of VaR, how should the management interpret this figure regarding the day's potential losses?

(A) There is a 99% chance that the daily loss will be exactly ₹200,000.
(B) There is a 1% chance that the loss will be greater than ₹200,000.
(C) There is a 99% chance that the loss will exceed ₹ 200,000.
(D) The maximum possible loss under any crisis phase is capped at ₹200,000.

May/June 2010

23. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option:

Assertion (A): Sovereign users may utilize Value at Risk (VaR) analysis to consider lengthening debt maturities.

Reason (R): VaR analysis draws attention to potentially dangerous scenarios, inducing countries to consider hedging foreign currency liabilities and taking measures to reduce risk levels.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2024

24. Which of the following equations correctly transforms a normal random variable X into a standard score (z score)?

(A) $z = \dfrac{(X-\sigma)}{\mu}$

(B) $z = \dfrac{(\mu - X)}{\sigma}$

(C) $z = \dfrac{(X \times \mu)}{\sigma}$

(D) $z = \dfrac{(X-\mu)}{\sigma}$

May/June 2017

25. A commercial bank adjusts its internal market risk models and must select appropriate holding periods for different desks. The trading desk holds highly liquid securities with rapid turnover, while the credit risk department holds long-term illiquid corporate bonds.

What time horizons should the bank appropriately set for the trading desk and the credit portfolio, respectively?

(A) 1-year horizon for the trading desk; 1-day horizon for the credit portfolio.
(B) 1-day horizon for the trading desk; 1-year horizon for the credit portfolio.

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43. (B) (I), (III), and (IV)
Calculating duration requires identifying future cash flows, computing their present values to determine the current bond price, and multiplying each present value by its timing. Aggregating these products and dividing by the price yields the duration. However, dividing by maturity in years is not a valid step in this process. Correct methodology ensures the metric accurately reflects interest rate sensitivity.

44. (A) (I) and (II) are correct
For any coupon-paying bond, the Macaulay duration is strictly less than its term to maturity because early payments reduce the weighted-average time. Additionally, a higher coupon rate leads to a lower duration because more value is returned to the investor sooner. However, it is incorrect to say duration always increases with maturity for all discount bonds under every market condition.

45. (C) INR 30,000,000
To fully hedge the primary bond position, the nominal value of the hedging instrument must be calculated using the hedge ratio. Dividing the primary PVBP of zero point zero nine five four by the hedging PVBP of zero point zero three one eight results in a ratio of three. Therefore, thirty million of the hedging bond must be sold short.

46. (A) P-1, Q-2, R-3, S-4
Various bond characteristics impact duration in predictable ways. A higher coupon rate lowers duration, while a lower yield to maturity increases it. Zero-coupon bonds have a duration exactly equal to their term to maturity. Generally, a longer term to maturity results in a higher duration. Understanding these relationships is vital for managing the interest rate sensitivity of a bond portfolio.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Mortgage-backed securities display negative convexity because falling interest rates encourage homeowners to refinance. This leads to early principal repayments, causing the investor to receive funds faster than originally expected. Consequently, the price of these securities does not rise as much as standard bonds when rates decline, as the cash flows are effectively shortened by the borrowers' refinancing actions.

48. (B) Immunization — Strategy that strictly maximizes yield curve upside while absorbing downside losses
Immunization is a risk management strategy aimed at stabilizing the value of a portfolio to meet future obligations, not a method to maximize upside gains. Reinvestment risk and liquidation risk are correctly defined as uncertainties regarding future yields and sale prices, respectively. The goal of immunization is to balance these risks so that the portfolio's target value remains stable.

49. (A) (I), (III), (IV), and (V)
Hedging with basis point values involves creating a position that results in a zero profit-and-loss outcome daily. This is achieved by shorting a security to offset a long position, using a hedge ratio calculated from respective PVBPs. While hedging protects against losses, it is not intended to improve the profit outlook, as it inherently limits potential gains from favorable movements.

50. (C) (II) and (III) are correct
Bond price volatility exhibits specific traits, such as the percentage price change being roughly symmetrical for small yield shifts. However, for large shifts, the percentage increase when yields fall is always greater than the percentage decrease when yields rise by the same amount. This asymmetry is a result of the convex nature of the price-yield curve, which is a fundamental concept.

51. (D) INR 9,600
The portfolio PVBP is determined by summing the monetary price changes of each bond for a one basis point shift. Bond X contributes two thousand one hundred, while Bond Y contributes seven thousand five hundred. Adding these amounts together results in a total portfolio PVBP of nine thousand six hundred, representing the aggregate risk for the combined bond holdings.

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to guarantee that future obligations can be met reliably.

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effective convexity must be combined. For a one hundred basis point rise, the calculation involves multiplying the duration by the yield change and adding the convexity adjustment. This process results in an approximate price decrease of two point four three nine percent, reflecting the bond's risk characteristics.

62. (A) Decrease by 2.000%
Using a modified duration of four, an increase in yield of fifty basis points results in a predictable change in the bond's market price. Since the relationship is inverse, a zero point five percent increase in yield multiplied by the duration of four leads to a two percent decrease in the price. This linear approximation is useful for small interest rate movements.

63. (C) Reduce the overall PVBP of the portfolio
When interest rates are expected to rise significantly, bond prices typically fall, leading to potential financial losses. To mitigate this risk, a dealer should reduce the overall PVBP of the portfolio. By lowering the sensitivity to basis point changes, the dealer protects the portfolio's value from the negative impact of increasing yields, maintaining a more stable financial position.

64. (C) Reinvestment income decreases, but the market price of the bond when sold increases, balancing each other
In an immunized portfolio, a drop in interest rates causes reinvestment income to decrease because coupons are reinvested at lower yields. However, this loss is offset by an increase in the market price of the bond. These two opposing forces balance each other out, allowing the investor to still meet the target obligation of two thousand at the specified future date.

65. (B) 2.5366
Effective duration is calculated by observing how the price of a bond changes when the yield is increased and decreased by a specific amount. In this case, the formula uses the price estimates of one hundred point one zero and one hundred five point three zero. The resulting value of two point five three six six represents the bond's price sensitivity.

66. (D) 4.0000
Modified duration is derived by dividing the Macaulay duration by one plus the periodic yield. With a Macaulay duration of four point one six and a semiannual yield of four percent, the calculation results in a modified duration of exactly four. This figure provides a direct measure of the bond's percentage price sensitivity to a unit change in yield.

67. (D) It precisely equals the target value of INR 2,000 needed to meet the obligation
If the market interest rate remains perfectly flat at the initial rate of six percent, the investment will grow exactly as projected. The coupons will be reinvested at the same rate, and the bond's value will evolve according to the original plan. Consequently, the accumulated value will precisely equal the target amount needed to satisfy the four-year obligation.

68. (A) 19.512
Effective convexity is calculated using the price changes resulting from a yield shift to measure the curvature of the price-yield relationship. Using the provided values for the callable bond, the calculation yields a result of nineteen point five one two. This measure helps analysts refine their price change estimates beyond what is provided by the first-order approximation of effective duration.

69. (B) INR 19.00
The absolute change in the bond's price is found by applying the calculated percentage change to the current market price. With a market price of nine hundred fifty and a two percent expected decrease, the price will drop by nineteen currency units. This monetary figure is essential for traders and risk managers to understand the actual financial impact of yield fluctuations.

70. (B) Target Date Immunization
Matching the duration of an asset to the duration of a specific future liability is the defining characteristic of Target Date Immunization. This strategy ensures that the portfolio is protected against interest rate risk by balancing price risk and reinvestment risk. It is commonly used by institutions like banks

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34. (D) Assertion (A) is false, but Reason (R) is true.
The assertion is incorrect because a perfect hedge is designed to neutralize both losses and gains, not to capture upside potential. However, the reason provided is accurate; the fundamental purpose of hedging is to maintain a zero profit-and-loss position by matching cash flows. Therefore, while hedging protects against downside risk, it also eliminates the possibility of benefiting from favorable movements.

35. (C) Both (I) and (II) are correct
Target date immunization is a robust strategy that ensures a specific stream of future cash outflows can be satisfied by a dedicated portfolio of assets. This is achieved by selecting fixed-income securities such that the total current value and the modified duration of the assets match those of the liability stream. This balance protects the portfolio's terminal value from interest rate fluctuations.

36. (A) INR 143,100
To calculate the expected monetary loss, multiply the PVBP by the basis point change and the nominal value factor. With a PVBP of zero point zero nine five four and a fifteen basis point increase, the calculation results in a loss of one hundred forty-three thousand one hundred. This represents the absolute decline in value for the primary bond position.

37. (A) P-4, Q-3, R-1, S-2
Different interest rate risk measures serve specific purposes in financial analysis. PVBP defines the absolute price change for a one basis point shift, while modified duration scales Macaulay duration by the market yield. Convexity accounts for the curvature of the price-yield relationship, and effective duration is used specifically for instruments with embedded options where cash flows might change with yields.

38. (D) (I), (II), and (III) are correct
Convexity is mathematically defined as the first derivative of modified duration or the second derivative of price with respect to yield. It measures the curvature of the price-yield relationship. If convexity is negative, any move in interest rates tends to reduce the overall returns for the investor. These properties are fundamental for assessing the risk profile of complex bond portfolios.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The estimation of price changes for large yield shifts is significantly improved by incorporating convexity. This is because modified duration is a linear approximation that loses accuracy as the yield change increases. The curved nature of the price-yield relationship means that duration alone cannot capture the full price movement, making convexity a necessary second-order correction for precise valuation.

40. (D) Ni — Number of days to maturity of Security i
In the context of bond formulas, the variable Ni typically represents the timing or maturity of a security in years, not the number of days. Accurate unit measurement is crucial for calculating weighted-average duration and other sensitivity metrics. Other components like the proportion of the portfolio and periodic cash flows are correctly identified in standard financial models for risk assessment.

41. (B) INR 76,800
The total portfolio loss is found by first calculating the contribution of each bond's PVBP to the overall value. For an eight basis point increase, the combined impact on Bond X and Bond Y results in a total financial loss of seventy-six thousand eight hundred. This calculation demonstrates how aggregate PVBP can be used to monitor the risk of multiple holdings.

42. (A) P-3, Q-4, R-1, S-2
Portfolio duration is determined by the weighted sum of individual durations, while the hedge ratio is the quotient of portfolio PVBP and hedge instrument PVBP. Modified duration adjusts Macaulay duration for yields, and effective duration uses price changes from yield shifts to value bonds with options. Matching these formulas to their identifiers is essential for proper technical analysis of fixed-income risks.

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CHAPTER 16
Value at Risk

May/June 2011

1. In the mathematical framework of Value at Risk (VaR), if p represents the given probability where $0 < p < 1$, which of the following identities correctly defines the VaR (V^*)?
(A) Prob [Loss $> V^*$] $= (1 - p)$
(B) Prob [Loss $< V^*$] $= p$
(C) Prob [Loss $= V^*$] $= p$
(D) Prob [Loss $> V^*$] $= p$

Oct/Nov 2022

2. The central Value at Risk (VaR) measurement exercise involves estimating a suitable percentile of change in value. Which of the following is NOT one of the main methodologies utilized to compute VaR?
(A) Parametric Method
(B) Historical Simulation
(C) Principal Component Analysis Method
(D) Monte Carlo Simulation

May/June 2019

3. Which of the following factors is NOT considered part of the convergence that brought about the Value at Risk (VaR) revolution?
(A) Emergence and widespread market adoption of complex financial products
(B) Globalization of financial markets leading to diverse risk exposure sources
(C) Shift from internal models to standardized external models
(D) Technological advances increasing institutional computing power and speed

Oct/Nov 2014

4. A portfolio manager needs to calculate the Value at Risk (VaR) for an equity portfolio with a mark-to-market position of 100 million . The standard deviation of daily returns is 2.5%. The manager needs to compute the 1-day VaR at a 99% confidence level.
Using the given quantile for a 99% confidence level ($\alpha = (-)2.326$), what is the reported potential loss?
(A) $(-)2{,}500{,}000$
(B) $(-)4{,}112{,}500$
(C) $(-)5{,}815{,}000$
(D) $(-)2{,}326{,}000$

May/June 2023

5. Which of the following statements about the assumptions for the calculation of Value at Risk (VaR) is incorrect?
(A) The stationarity requirement assumes that an 'x' percent fluctuation in returns is equally likely to occur at any point in time.
(B) The random walk assumption implies that day-to-day fluctuations in returns are highly correlated and predictive of future returns.
(C) The nonnegativity requirement stipulates that financial assets with limited liability cannot attain negative values.
(D) The distributional assumption commonly posits that daily return fluctuations in a portfolio follow a normal distribution.

Oct/Nov 2008

6. Which of the following represents the correct sequential order of steps involved in the Historical Simulation method for computing Value at Risk (VaR)?
I Sort the portfolio values from the best to the worst.
II Revalue the current portfolio based on changes in risk factors.
III Determine VaR by identifying the required percentile.
IV Tabulate daily changes in risk factors identified for the portfolio.
V Plot the distribution of portfolio values.
(A) IV, II, V, I, III
(B) II, IV, I, V, III
(C) IV, V, II, III, I
(D) I, II, III, IV, V

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May/June 2007

7. When was the concept of Value at Risk (VaR) first introduced in the regulatory domain by the Bank for International Settlements (BIS) in the context of measuring market risk?
(A) 1990
(B) 1994
(C) 1996
(D) 1998

Oct/Nov 2025

8. Picking a 99.99% confidence level for a daily Value at Risk (VaR) should theoretically lead, on average, to one incident of loss exceeding the VaR out of how many trading days?
(A) 1,000 trading days
(B) 2,500 trading days
(C) 5,000 trading days
(D) 10,000 trading days

May/June 2016

9. According to the empirical rule (the 68-95-99.7 rule) for a normal distribution, approximately what percentage of the area under the curve falls within 2 standard deviations of the mean?
(A) 68%
(B) 95%
(C) 99%
(D) 99.7%

Oct/Nov 2018

10. Match the application of Value at Risk (VaR) by users (List I) with the corresponding purpose or entity (List II):
List I: (Application)
P. Passive Application
Q. Defensive Application
R. Active Application
S. Nonfinancial corporations
List II: (Purpose)
1. Setting position limits for traders and business units.
2. Allocating capital across traders, business units, and the whole institution.
3. Measuring and reporting of risk to rank portfolios in order of risk.
4. Using Cash flow at risk analysis to anticipate critical shortfalls of funds.
(A) P-1, Q-2, R-3, S-4
(B) P-4, Q-3, R-1, S-2
(C) P-3, Q-1, R-2, S-4
(D) P-2, Q-4, R-3, S-1

May/June 2012

11. Consider the following statements regarding the limitations of the Historical Simulation approach for calculating Value at Risk (VaR):
I It is computationally efficient for a portfolio containing complex securities.
II It cannot account for structural changes in the market unless a sufficient time period has elapsed and the necessary data under the new market structure is available.
Which of the above statement(s) is/are correct?
(A) Both (I) and (II) are correct.
(B) Both (I) and (II) are incorrect.
(C) Only (I) is correct.
(D) Only (II) is correct.

Oct/Nov 2006

12. Consider the following statements regarding the fundamental definition of Value at Risk (VaR):
I VaR represents the trivial maximum possible loss, meaning the entire portfolio value is wiped out.
II A 95% VaR is the size of the loss that will be exceeded with only a 5% probability.
III VaR is a percentile of the profit and loss distribution of a portfolio over a specified horizon.
Which of the following combination of statements is correct?
(A) (I) and (II)
(B) (I) and (III)
(C) (II) and (III)
(D) (I), (II), and (III)

May/June 2021

13. What does the historical database building process for Value at Risk (VaR) fundamentally depend on to calculate overall risk once individual instrument data is centralized?
(A) Aggregating the risks from individual instruments across the entire portfolio.
(B) Assuming a uniform single volatility metric for all asset classes.
(C) Replacing past highly volatile data points with standard average median values.
(D) Exclusively generating hypothetical random future price scenarios without past data.

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Oct/Nov 2010

14. Why is the normal distribution assumption in Value at Risk (VaR) calculations often considered unpalatable for instruments like options?

(A) Options are strictly linear derivatives and follow a uniform probability distribution.

(B) Options are completely risk-free if hedged and do not require any distributional assumptions.

(C) Options typically have highly skewed return distributions rather than normal distributions.

(D) Options returns are strictly mean-reverting and easily predictable over short horizons.

May/June 2005

15. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option:

Assertion (A): The square root of time scaling approach easily extrapolates 1-day volatilities to longer horizons without limits on its utility.

Reason (R): The method assumes that daily price moves are independent of each other, and that there is no mean reversion, trending, or autocorrelation in markets.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2016

16. Which of the following is the correct chronological sequence of events related to the historical development of risk management and Value at Risk (VaR)?

I The chairman of JP Morgan requested a daily '4:15 report' indicating risk and potential losses across the trading portfolio.

II JP Morgan decided to make its data and basic methodology available so outside parties could use them.

III The pioneering work of Harry Markowitz laid the foundation for risk management theory and practice.

IV Major financial institutions started working on internal models to measure and aggregate risks for internal purposes.

(A) (III), (IV), (I), (II)

(B) (IV), (III), (II), (I)

(C) (III), (I), (IV), (II)

(D) (I), (III), (IV), (II)

May/June 2018

17. Which combination correctly represents the five steps involved in computing Value at Risk (VaR)?

I Set confidence level.

II Measure the variability or the standard deviation of the risk factor.

III Report worst potential loss.

IV Set time horizon.

V Compute the mark to market position of the portfolio.

(A) (I), (II), (III), (IV), and (V)

(B) (I), (II), and (III) only

(C) (II), (IV), and (V) only

(D) (I), (III), (IV), and (V) only

Oct/Nov 2007

18. Consider the following statements regarding the formulation of Value at Risk (VaR) using changes in the value of an underlying position:

I The change in value of the position from time t to $t+h$ is denoted as $\Delta W_t(h) = (W_{t+h} - W_t)$.

II The value-at-risk V^* satisfies the identity $\text{Prob}[\Delta W_t(h) < -V^*] = p$.

Which of the above statement(s) is/are correct?

(A) Both (I) and (II) are correct.

(B) Both (I) and (II) are incorrect.

(C) Only (I) is correct.

(D) Only (II) is correct.

NODIA

May/June 2025

19. Identify the incorrect pair regarding the probability density function (PDF) and the normal curve parameters:

(A) Mean of the distribution - Determines the location of the center of the graph.

(B) Standard deviation - Determines the height and width of the graph.

(C) Normal distributions - Visually look like a symmetric, bell-shaped curve.

(D) Small standard deviation - The resulting

52. (D) For bonds selling at high discount, duration may decrease with increasing maturity
A key property of duration is that for bonds selling at a very high discount, duration may actually decrease as maturity increases. This occurs because the impact of the final principal payment becomes less significant relative to the earlier cash flows when discount rates are extreme. This exception highlights the complexity of duration as a measure of interest rate sensitivity.

53. (C) Both (I) and (II) are correct
Positive convexity is beneficial because it results in larger price gains when yields fall compared to the losses incurred when yields rise by the same amount. Conversely, mortgage-backed securities can exhibit negative convexity because lower interest rates trigger refinancing, which limits price appreciation. Both statements accurately describe how convexity affects the risk and return profiles of different fixed-income financial instruments.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The Macaulay duration of a coupon-paying bond is always less than its term to maturity because the periodic interest payments are received before the final principal. These early cash flows are weighted in the calculation, which reduces the effective maturity compared to a zero-coupon bond. This fundamental principle explains why duration is a more accurate measure of timing than maturity.

55. (A) (II), (III), and (IV) are correct
Effective bond portfolio management involves addressing reinvestment risk, which arises from uncertain interim rates, and liquidation risk, which concerns future sale prices. Immunization techniques focus on matching the interest rate exposure of assets and liabilities to stabilize net worth. It is important to note that bank liabilities are typically short-term deposits, which results in a relatively low duration.

56. (A) P-2, Q-3, R-4, S-1
Interest rate risk components have distinct characteristics. Reinvestment risk involves uncertainty about future yields for interim cash flows, while liquidation risk concerns the future sale price of a bond. Target date immunization is achieved by matching asset and liability durations and values. Together, these factors influence the net worth of a firm and its ability to meet long-term obligations.

57. (A) 3.0000
The hedge ratio is calculated by dividing the PVBP of the primary position by the PVBP of the hedging instrument. In this scenario, dividing zero point zero nine five four by zero point zero three one eight results in a value of three point zero. This ratio indicates the relative size of the hedge needed to neutralize the interest rate risk.

58. (A) Only (I) is correct
Effective duration and convexity are essential for accurately calculating the price sensitivity of bonds with embedded options, as these metrics account for potential changes in cash flows. Standard modified duration and convexity assume that cash flows remain constant despite yield shifts. Therefore, for complex securities like callable bonds, effective measures provide a more realistic assessment of interest rate risk.

59. (C) (II), (III), and (V)
Securities with high positive convexity are said to be long volatility because they benefit from large interest rate movements. When managing risk, matching convexity ensures that the assets and liabilities respond similarly to rate shifts. It is also important to remember that modified duration assumes cash flows are fixed, making it a linear approximation of the price-yield relationship in markets.

60. (B) (I) and (II) are correct
The PVBP approach is valued for its simplicity and its ability to aggregate risk across a portfolio of transactions by summing individual PVBPs. It measures the absolute change in bond price for a one basis point movement. However, it does not accurately predict non-parallel shifts in the yield curve, as it assumes all rates move in unison across different maturities.

61. (C) -2.4390%
To estimate the percentage price change, the effects of both effective duration and

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(C) 1-month horizon for both portfolios to maintain reporting consistency.
(D) 10-day horizon for the trading desk; 1-month horizon for the credit portfolio.

Oct/Nov 2005

26. How is market risk defined in the context of predicting Value at Risk (VaR)?
(A) Probability of counterparty default occurring prior to the final settlement of a transaction.
(B) Uncertainty of future earnings derived from internal operational processes and system failures.
(C) Maximum likely loss occurring during a complete market crash that wipes out the portfolio.
(D) Potential loss from unexpected volatility in asset, equity, or earnings value.

May/June 2020

27. A risk analyst has calculated the 1-day Value at Risk (VaR) for a portfolio at ₹4,112,500. Management now requires the VaR to be extrapolated to a monthly horizon (21 days) using the square root of time scaling method. What is the approximate Monthly VaR?
(A) ₹4,112,500 × 4.58
(B) ₹4,112,500 × 21
(C) ₹4,112,500 × 2.24
(D) ₹4,112,500 × 5

Oct/Nov 2015

28. A multinational corporation frequently handles cash inflows and outflows denominated in multiple currencies and is highly susceptible to adverse currency swings.
The CFO wishes to implement a centralized risk management approach to determine the likelihood of a critical shortfall in funds. Which specific application of Value at Risk (VaR) concepts is most appropriate for this corporation?
(A) Cash flow at risk
(B) Earnings at risk
(C) Credit value at risk
(D) Regulatory capital at risk

May/June 2013

29. In the context of probability and the normal curve, what is the primary difference between likelihood questions and quantile questions?
(A) Likelihood questions specify the target probability to identify the quantile, while quantile questions use the amount to identify probability.
(B) Likelihood questions utilize the inverse normal distribution exclusively, while quantile questions utilize the standard normal distribution for linear assets.
(C) Likelihood questions specify the quantity to find the associated probability, while quantile questions use probability to find the associated amount.
(D) Likelihood questions apply solely to non-linear portfolios, while quantile questions are used exclusively to evaluate linear portfolio return distributions.

Oct/Nov 2021

30. Identify the correct pair regarding the building blocks of Value at Risk (VaR):
(A) Time horizon for commercial bank trading portfolios - Typically chosen as 1-year due to rapid turnover.
(B) Confidence level - Defined purely by the liquidation period of a portfolio regardless of the required certainty.
(C) Time horizon for credit portfolios - Typically chosen as a daily horizon due to less liquid assets.
(D) Liquidation period - The time required to liquidate a portfolio or to hedge the market risks.

May/June 2024

31. According to the comparative advantages and disadvantages of various methods, which of the following is NOT a disadvantage of the Monte Carlo simulation?
(A) It is computationally intensive and time-consuming.
(B) It involves revaluing the portfolio under each generated scenario.
(C) It is definitively less accurate for nonlinear portfolios compared to the parametric method.
(D) It quantifies fat-tailed risk only if market scenarios are explicitly generated from the appropriate distributions.

Oct/Nov 2017

32. A bank's risk management team decides to conduct a stress test by moving specific

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risk factors in isolation by large amounts to explicitly gauge the portfolio's sensitivity to each individual risk factor. Which specific approach to creating stress scenarios does this describe?

(A) Generating historical scenarios based on days when markets moved violently.
(B) Introducing market shocks.
(C) Creating anticipatory scenarios moving many market factors consistently.
(D) Setting up port-portfolio-specific stress tests based on the weaknesses of the portfolio itself.

May/June 2006

33. The Monte Carlo simulation method is described as a process involving the following steps:

I Listing all the risk factors and their dynamics (such as volatilities, correlations, and mean reversion factors).
II Constructing time paths by simulating over smaller periods until the target period is reached.
III Repeating the path construction a large number of times to generate the distribution and obtain values for risk factors used as inputs into pricing models.

Which of the above statements accurately describe these steps?

(A) (I) and (II)
(B) (I), (II), and (III)
(C) (II) and (III)
(D) (I) and (III)

Oct/Nov 2013

34. A bank utilizes an internal Value at Risk (VaR) model for market risk capital requirements. Over the last quarter, actual trading losses exceeded the VaR predicted confidence bands on multiple occasions, which is statistically unacceptable based on the chosen confidence level.

To avoid BIS penalties, the risk management team investigates the cause. Which of the following is a direct area they should probe to find the cause of this poor model performance?

(A) The physical security measures of the corporate trading floor.
(B) The individual personal investment accounts of the junior traders.
(C) The marketing budget allocated for the bank's mutual funds and asset managers.
(D) The integrity of position and market data, methodology, and model parameters.

May/June 2008

35. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option:

Assertion (A): The basic premise of estimating the tail-index in Extreme Value Theory (EVT) stems from the result that the tails of every fat-tailed distribution converge to the tails of Pareto distribution.

Reason (R): EVT involves estimating the conditional distribution of the excess beyond a very high threshold.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2012

36. Consider the following statements about Value at Risk (VaR) principles:

I If the daily VaR of a trading portfolio is ₹5mln at a 95% confidence level, the loss is expected to be more than ₹5 mln on 5 days out of 100 days.
II As per Basel Committee requirements, the VaR is required to be calculated to measure market risk over a 10-day horizon.
III The Parametric method assumes it can predict loss under normal conditions effectively.
IV If the daily VaR is ₹1 mln, the value of a 5-day VaR is mathematically equivalent to exactly 5 mln without any scaling adjustment.

Which of the above statements are correct?

(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), and (IV)

NODIA

May/June 2015

37. A risk manager is employing the Historical Simulation method using exactly 100 recent daily outcomes of portfolio returns. After arranging the returns in descending order, the outcomes range from 4.93% (best) down to -4.95% (worst).
If the risk manager wants to calculate the 1-day Value at Risk (VaR) at a 95% confidence level, which rank of outcome (from the bottom) represents the cutoff loss?
(A) The absolute largest loss
(B) The 5^{th} largest loss
(C) The 6^{th} largest loss
(D) The 95^{th} largest loss

Oct/Nov 2020

38. What describes a "bottom-up approach" in the context of stress testing?
(A) Asking how much the firm could lose in a major equity market crash strictly from a senior management perspective.
(B) Designing portfolio-specific stress tests based primarily on the perceived strengths and historical resilience of the portfolio itself.
(C) Applying historical simulation starting from the oldest available data point and rolling up to the present day.
(D) Aggregating scenarios from individual risk takers for cross-firm analysis of diversification or exacerbation.

May/June 2022

39. A comprehensive business risk analysis during a stress test anticipates a major long-term equity market downturn.
Apart from calculating the direct losses on trading and investment positions, the risk manager estimates the effect of structurally lower demand for equity underwriting over the coming months. What type of effect is the manager assessing in this scenario?
(A) Immediate direct effect on the present mark-to-market portfolio.
(B) Mathematical model risk error due to unstated assumptions.
(C) Pure implementation risk stemming from the IT systems.
(D) Indirect loss / longer-term indirect effects on a firm's well-being.

Oct/Nov 2023

40. What is a primary reason that Value at Risk (VaR) estimates can be subject to 'model risk'?
(A) Models take historical rates exactly as they happened without relying on any future distribution assumptions.
(B) Models may be based on inappropriate assumptions regarding market behavior or distributions.
(C) The sample size used in the model guarantees coverage of the 68-95-99.7 empirical rule, ignoring fat tails entirely.
(D) Models fail to incorporate the fixed interest payments of sovereign bonds in liquid markets.

Oct/Nov 2009

41. A risk analyst attempts to estimate the Value at Risk (VaR) using a Monte Carlo simulation for a highly complex portfolio with non-linear derivatives.
After 50,000 iterations, the model runs smoothly, but the analyst realizes the output is heavily dependent on chosen, potentially flawed mean reversion factors and volatilities. What specific type of risk does the Monte Carlo Simulation method become particularly prone to if these inputs are incorrectly assumed?
(A) Liquidity risk stemming from the inability to sell assets quickly.
(B) Operational risk arising from inadequate internal controls or human error.
(C) Model risk originating from inaccurate parameter estimations or flawed assumptions.
(D) Sovereign risk involving the potential default of a national government.

May/June 2014

42. What defines the "Parametric" method of calculating Value at Risk (VaR)?
(A) It estimates VaR by simulating random scenarios and sequentially revaluing positions in the portfolio.
(B) It estimates VaR by reliving history and taking actual historical rates over a 500-day period.
(C) It estimates VaR with an equation that specifies parameters such as volatility, correlation, delta, and gamma.
(D) It measures residual risk beyond maximum

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loss using the conditional distribution of excess values.

Oct/Nov 2010

43. What is the first basic step required among the three steps for stress testing?
(A) Revalue portfolio
(B) Generate scenarios
(C) Summarize results
(D) Determine the tail-index

May/June 2012

44. Which of the following statements regarding Extreme Value Theory (EVT) is incorrect?
(A) EVT focuses only on the tail of a probability distribution, making the method potentially more flexible.
(B) EVT cannot accommodate skewed and fat-tailed distributions, making it essentially identical to the basic parametric approach.
(C) A problem with EVT is adapting it to a situation where many risk factors drive the underlying return distribution.
(D) EVT is notable for being a technique that attempts to attach a probability to stress test results.

Oct/Nov 2014

45. Match the following risk management concepts (List I) with their specific characteristics (List II):
List I: (Concept)
P. Confidence level
Q. Historical Simulation
R. Monte Carlo Simulation
S. Value at Risk
List II: (Characteristic)
1. A procedure of calculating VaR using actual past data to assess the impact of market moves.
2. Expressed as a percentage indicating the probability that the actual loss will not exceed the VaR.
3. The predicted worst-case loss at a specific confidence level over a certain period under normal conditions.
4. Models the probability of different outcomes by generating random hypothetical scenarios.
(A) P-1, Q-3, R-4, S-2
(B) P-4, Q-2, R-1, S-3
(C) P-2, Q-1, R-4, S-3
(D) P-3, Q-4, R-2, S-1

May/June 2019

46. A bank manages an equity portfolio valued at ₹10 million. Using historical simulation with 100 data points, the sixth largest loss is observed as (-) 4.64%.
What is the calculated Value at Risk (VaR) at the 95% confidence level for a 1-day horizon?
(A) ₹ 10,000,000 times (-) 0.05
(B) ₹464,000
(C) ₹950,000
(D) ₹4,640,000

NODIA

Oct/Nov 2006

47. Identify the incorrect pair regarding the processes related to Back Testing:
(A) Poor model performance - Prompts probing to find the cause, such as checking the integrity of position and market data.
(B) Primary function of back testing - Correcting the past historical data points directly to perfectly match the theoretical model.
(C) Observation during tests - Checking whether trading results fall within pre-specified confidence bands predicted by Value at Risk (VaR) models.
(D) Regulatory body imposing penalty - Bank for International Settlements (BIS).

May/June 2021

48. A hedge fund primarily trades in highly non-linear derivatives and heavily skewed financial instruments.
The chief risk officer wants to implement a Value at Risk (VaR) methodology but refuses to make any distributional assumptions or perform parameter fitting. The fund has an extensive, relevant daily rate history for the past three years. Which VaR methodology is best suited for this portfolio based on these specific constraints?
(A) Parametric method
(B) Historical simulation
(C) Monte Carlo simulation
(D) Variance/Covariance Method

Oct/Nov 2011

49. Match the step or concept of stress testing (List I) with its corresponding action (List II):
List I: (Step/Concept)

P. Generate scenarios
Q. Revalue portfolio
R. Summarize results
S. Creating anticipatory scenarios

List II: (Action)

1. Show expected levels of mark-to-market loss and where business area losses would be concentrated.
2. Address both the magnitude of movement of market variables and the interrelationship of variables.
3. Marking-to-market all financial instruments under new worst case market rates.
4. Moving many market factors in a consistent fashion to approximate real moves of all relevant world markets.

(A) P-2, Q-3, R-1, S-4
(B) P-3, Q-2, R-4, S-1
(C) P-1, Q-4, R-3, S-2
(D) P-4, Q-1, R-2, S-3

May/June 2009

50. Which of the following describe the characteristics and purposes of Stress tests?

I They are designed to estimate potential economic losses in abnormal markets.
II They enhance transparency by exploring a range of potential low-probability high-impact events.
III They completely replace Value at Risk (VaR) as the primary benchmark risk measure for standard daily normal trading conditions.
IV They try to answer questions like "How much could I lose if a stress scenario occurs?"

Which of the above statements are correct?
(A) (I), (II), and (IV)
(B) (II), (III), and (IV)
(C) (I), (II), and (IV)
(D) (I), (III), and (IV)

Oct/Nov 2024

51. A financial institution computes the daily Value at Risk (VaR) of a trading portfolio as ₹1 million.

A regulator asks the institution to provide the 5-day VaR to assess standard market risk. Using the square root of time scaling method, what is the value of the 5-day VaR?

(A) 1.00 million
(B) 2.24 million
(C) 5.00 million
(D) 10.00 million

May/June 2025

52. Match the Value at Risk (VaR) calculation methodology (List I) with its corresponding application strength or weakness (List II):

List I: (Methodology)

P. Parametric
Q. Historical simulation
R. Monte Carlo simulation
S. All three approaches

List II: (Characteristic)

1. Less accurate for nonlinear portfolios or for skewed distributions.
2. Quantifies fat-tailed risk only if market scenarios are explicitly generated from appropriate distributions.
3. Difficult to scale far into the future (long horizons) without strong assumptions.
4. Vulnerable to regime shifts or sudden changes in market behavior.

(A) P-4, Q-2, R-3, S-1
(B) P-1, Q-2, R-4, S-3
(C) P-3, Q-1, R-2, S-4
(D) P-1, Q-3, R-2, S-4

Oct/Nov 2007

53. What is Extreme Value Theory (EVT) in the context of risk management?

(A) A comprehensive management method designed to completely eliminate the risk of loss in globally abnormal markets.
(B) An approach that assumes all future price changes will strictly follow a central normal distribution curve.
(C) Statistical theory analyzing probability distribution "tails" to capture risk in extreme circumstances.
(D) A regulatory penalty applied by central banks to institutions whose standard VaR models perform poorly over a year.

May/June 2023

54. Identify the correct pair regarding Back Testing of Value at Risk (VaR) Models:

(A) Objective of Back testing - To generate forward-looking hypothetical market scenarios based on Monte Carlo simulations.

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ANSWERS

1. (D) $Prob[Loss > V^*] = p$
Value at Risk (VaR) is a statistical measure of risk. Mathematically, it defines a threshold such that the probability of loss exceeding this specific value over a given time period is equal to a specified probability level. This relationship ensures that extreme losses beyond the calculated amount occur only with the frequency dictated by the chosen probability.

2. (C) Principal Component Analysis Method
Common methodologies for computing Value at Risk include the parametric method, historical simulation, and Monte Carlo simulation. These techniques utilize different statistical approaches to estimate potential losses. While Principal Component Analysis is a valuable statistical tool for reducing dimensionality in complex datasets, it is not considered one of the primary standalone frameworks used to measure daily risk.

3. (C) Shift from internal models to standardized external models
The Value at Risk revolution was driven by several key factors within the financial industry. These include the emergence of complex financial products, the globalization of markets, and significant technological advancements in computing speed. Conversely, the industry trend actually involved a move toward sophisticated internal models developed by institutions rather than a shift toward standardized external modeling tools.

4. (C) (-) ₹ 5,815,000
To compute the potential loss, the position value is multiplied by the standard deviation and the appropriate quantile for the specified confidence level. With a market value of one hundred million, a daily standard deviation of two point five percent, and a ninety-nine percent confidence quantile of two point three two six, the resulting calculation yields the loss.

5. (B) The random walk assumption implies that day-to-day fluctuations in returns are highly correlated and predictive of future returns.
The random walk assumption in financial modeling posits that day-to-day fluctuations in asset returns are independent and identically distributed. This implies that past price movements have no predictive power for future returns and that consecutive price changes are not correlated. Suggesting that these fluctuations are highly correlated and predictive contradicts the fundamental principles of the random walk hypothesis.

6. (A) IV, II, V, I, III
The historical simulation process begins with tabulating daily changes in identified risk factors. Next, the current portfolio is revalued based on these historical changes to create a range of potential values. These values are then plotted in a distribution and sorted from best to worst. Finally, the specific Value at Risk is determined by identifying the required percentile.

7. (C) 1996
The concept of Value at Risk gained significant regulatory prominence through the efforts of international financial bodies. The Bank for International Settlements formally introduced the use of internal models based on this risk metric in the context of market risk measurement in nineteen ninety-six. This milestone established a standardized regulatory framework for global banks to manage their trading exposures.

(D) 10,000 trading days
A confidence level of ninety-nine point nine nine percent implies that there is only a zero point zero one percent probability of a loss exceeding the calculated Value at Risk. Statistically, this translates to one such extreme event occurring every ten thousand trading days. This extremely high confidence level requires vast amounts of data to verify through back testing.

NODIA

true.

May/June 2018

60. Consider the following statements about extreme values and financial positions:

I The holder of a short financial position suffers a loss when the prices of underlying assets rise, and concentrates on the upper-tail of the distribution.

II The holder of a long financial position models the lower tail of the return distribution, as a negative return on underlying assets makes the bank suffer a loss.

Which of the above statement(s) is/are correct?

(A) Both (I) and (II) are correct.
(B) Both (I) and (II) are incorrect.
(C) Only (I) is correct.
(D) Only (II) is correct.

Oct/Nov 2015

61. A bank strictly employs a parametric approach for its 1-day Value at Risk (VaR) calculation. The assumed daily volatility is 100 basis point = 1.00% and the mean return is zero. Suddenly, the central bank unexpectedly intervenes, causing an immediate massive currency devaluation which had never occurred in the past 10 years.

The historical daily returns used to calibrate the parametric model do not contain any such devaluation events. Consequently, the actual loss exceeds the VaR estimate by 500%. This scenario primarily illustrates the fundamental vulnerability of all VaR approaches to:

(A) Simple standard deviation arithmetic computational errors.
(B) The routine enforcement of the random walk assumption for linear derivatives.
(C) Regime shifts or sudden unprecedented changes in market behavior.
(D) Strict nonnegativity requirements capping potential profits.

May/June 2020

62. The Monte Carlo simulation method calculates the change in the value of a portfolio using randomly generated price scenarios. Which of the following is NOT typically required as an assumption about market structures to configure this simulation effectively?

(A) A strict 10-day historical data limit to avoid computational over-processing.
(B) The observed historical correlations existing between various identified risk factors.
(C) Current volatility measures associated with the specific risk factors being modeled.
(D) Specific mean reversion factors applied to long-term interest rate stochastic processes.

Oct/Nov 2016

63. In the context of statistical assumptions and risk measurement methodologies, what does the term "leptokurtosis" address?

(A) The assumption of a completely normal distribution for returns within a perfectly linear financial portfolio.
(B) The specific phenomenon of having strictly flat tails within a standard uniform probability distribution.
(C) Presence of fat tails where extreme market moves occur more frequently than normal distributions suggest.
(D) The rapid turnover of liquid assets strictly within a commercial bank's trading book.

May/June 2017

64. In the context of probability theory and the standard normal curve, which statement is mathematically incorrect?

(A) A Probability Density Function (PDF) gives a complete representation of possible random outcomes and how likely they are.
(B) The inverse normal distribution calculates ranges of values for specific probabilities, which is necessary for computing confidence intervals.
(C) Quantile questions specify the probability to ask about the probability amount instead of the cutoff value.
(D) The normal curve visually conforms to a symmetric, bell-shaped structure dependent on the mean and standard deviation.

Oct/Nov 2005

65. The comparison of different methodologies highlights the varied necessity for historical data. Consider the following statements:

I The Parametric method does not need extensive historical data; only a volatility

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(B) BIS penalty - Imposed exclusively on institutions whose VaR models accurately predict normal market moves.
(C) Compare realized trading results with model-generated risk measures to evaluate new models and reassess existing ones.
(D) Frequency of back testing - Typically done on a decadal basis to verify absolute mathematical accuracy.

Oct/Nov 2022

55. Good stress tests should possess specific characteristics, such as:
I Be relevant to current positions.
II Examine potential regime shifts.
III Consider changes in all relevant market rates.
IV Consider market illiquidity.
V Consider the interplay of market and credit risk.
Which of the above characteristics accurately reflect good stress tests?
(A) (I), (II), (III), (IV), and (V)
(B) (I), (II), and (III) only
(C) (II), (III), (IV), and (V) only
(D) (I), (III), (IV), and (V) only

May/June 2016

56. How does the Monte Carlo simulation fundamentally differ from the Historical Simulation method in terms of scenario generation?
(A) Monte Carlo generates random hypothetical scenarios, while Historical Simulation takes actual past market movements as scenarios.
(B) Monte Carlo relies strictly on linear distributions, whereas Historical Simulation generates scenarios using multivariate distributions.
(C) Monte Carlo uses exactly 100 data points maximum, while Historical Simulation uses millions of random iterations.
(D) Monte Carlo avoids revaluing positions in the portfolio, whereas Historical Simulation explicitly requires position revaluation.

Oct/Nov 2018

57. In the context of financial risk management, what is the ultimate overarching goal of deploying Value at Risk (VaR) alongside Stress Testing and Back Testing?
(A) Develop a robust risk profile, evaluate limitations, and improve fundamental assumptions.
(B) To establish a comprehensive guarantee that zero financial losses occur across all institutional portfolios globally.
(C) To definitively eliminate the need for maintaining any internal regulatory capital requirements.
(D) To automatically initiate trades on behalf of the institution during severe events like an Asian crisis.

May/June 2005

58. A bank uses the Parametric Value at Risk (VaR) method to assess its daily risk.
A recent internal audit highlighted that the model systematically underestimates losses during severe market shocks. The risk committee points out that the methodology relies on a specific distribution that does not capture extreme, fat-tailed events adequately.
What distribution is the Parametric approach implicitly assuming, leading to this weakness?
(A) Normal distribution
(B) Pareto distribution
(C) T-distribution
(D) Uniform distribution

NODIA

Oct/Nov 2019

59. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option:
Assertion (A): Stress test results generally change in present value, not Value at Risk (VaR).
Reason (R): Revaluing a portfolio during stress testing involves marking-to-market all financial instruments under new worst case market rates.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is

May/June 2008

70. Why is it practically impossible to fully verify the Value at Risk (VaR) probability associated with a 99.99% confidence level utilizing standard back testing methods?

(A) Because standard back testing software algorithms are mathematically unable to process historical data sets beyond a 99% confidence level limit.

(B) It requires one incident per 10,000 days (approx. 40 years), making verification data unfeasible to collect.

(C) Because current global market regulations and Basel standards strictly prohibit the internal back testing of confidence levels exceeding 99%.

(D) Because the Monte Carlo simulation automatically resets extreme thresholds at the 99.90% confidence level to prevent system errors.

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and correlation matrix are required.

II Historical simulation requires a significant amount of daily rate history to function effectively.

III Monte Carlo simulation strictly requires a 500-day exact replica of historical unadjusted data to generate random scenarios.

Which of the above statements are correct?

(A) Only Statement (I) is correct.

(B) Both Statement (I) and Statement (II) are correct.

(C) Both Statement (I) and Statement (III) are correct.

(D) All Statements (I), (II), and (III) are correct.

May/June 2013

66. Which of the following statements regarding the Parametric method's characteristics and limitations is incorrect?

(A) It is generally less accurate for nonlinear portfolios or for skewed distributions.

(B) It assumes normally distributed returns, which implies that parametric Value at Risk (VaR) is only meant to describe "bad" losses on a "normally bad" day.

(C) It offers fast and simple calculations requiring only a volatility and correlation matrix, eliminating the need for extensive historical data generation.

(D) It provides a full distribution of potential portfolio values rather than just a specific percentile limit.

Oct/Nov 2021

67. What is the primary focus of the general mathematical formulation $P(L > VAR) \leq 1 - c$ regarding a portfolio?

(A) To provide a mathematical guarantee that total actual losses will never occur below the required confidence level c.

(B) To definitively state that the VaR is strictly equal to the entire portfolio value multiplied by $1 - c$.

(C) To show that VaR is always reported as a negative mathematical number representing expected operational profit.

(D) Formalize that the probability of loss L exceeding VaR is less than or equal to $1 - c$.

May/June 2006

68. Match the following Value at Risk (VaR) equation or formula elements (List I) with their corresponding descriptions (List II):

List I: (Element)

P. p

Q. c

R. z

S. α

List II: (Description)

1. The confidence level and time horizon parameter utilized in the general VaR definition $P(L > VAR) \leq 1 - c$.
2. The probability measure defined in the probabilistic framework where $0 < p < 1$.
3. Standard score utilized to transform a normal random variable via the equation $(X - \mu)/\sigma$.
4. Quantile representing a cutoff value such that the area to its right (or left) represents a given probability.

(A) P-2, Q-1, R-3, S-4

(B) P-1, Q-2, R-4, S-3

(C) P-3, Q-4, R-1, S-2

(D) P-4, Q-3, R-2, S-1

Oct/Nov 2008

69. Consider the following applications of Value at Risk (VaR) across different categories of users:

I Commercial banks use it for determining position limits for traders and internal risk capital.

II Nonfinancial corporations use it for Cash flow at risk analysis.

III Asset managers use it to assess total capital at risk on a portfolio basis.

IV Sovereign users utilize it to draw attention to scenarios, inducing consideration of hedging foreign currency liabilities.

V Regulators use it as a benchmark risk measure for determining minimum required capital under the internal model approach (IMA).

Which of the above combination of statements is correct?

(A) (I), (II), (III), and (V) only

(B) (I), (II), (III), (IV), and (V)

(C) (II), (III), (IV), and (V) only

(D) (I), (III), (IV), and (V) only

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9. (B) 95%
In a normal distribution, the empirical rule provides a standardized way to understand the spread of data around the mean. Approximately sixty-eight percent of the data falls within one standard deviation. For two standard deviations, about ninety-five percent of the area under the bell curve is captured, while three standard deviations cover ninety-nine point seven percent of the data.

10. (C) P-3, Q-1, R-2, S-4
Different users apply Value at Risk for various strategic purposes. Passive applications involve measuring and reporting risk to rank portfolios. Defensive applications focus on setting position limits for traders to control exposure. Active applications utilize this metric for capital allocation across business units. Finally, nonfinancial corporations employ cash flow at risk to anticipate critical fund shortfalls.

11. (D) Only (II) is correct.
Historical simulation relies entirely on past data, which makes it unable to account for structural market changes until enough new data becomes available. While it is conceptually straightforward, it can be computationally burdensome for portfolios containing very complex securities requiring full revaluation. Therefore, statement two correctly identifies a primary limitation, whereas statement one mischaracterizes the method's computational efficiency.

12. (C) (II) and (III)
Value at Risk represents a specific percentile of the profit and loss distribution over a set time horizon. It indicates the size of the loss that will be exceeded with a specific, low probability, such as five percent in a ninety-five percent confidence model. It does not represent the absolute maximum possible loss that would wipe out a portfolio.

13. (A) Aggregating the risks from individual instruments across the entire portfolio.
Building a historical database for risk management involves centralizing data from individual financial instruments. Once this information is collected and cleaned, the core process involves aggregating these individual risks across the entire portfolio. This consolidated view allows risk managers to calculate the overall potential loss by considering the combined impact of all holdings within the institutional framework.

14. (C) Options typically have highly skewed return distributions rather than normal distributions.
The assumption of a normal distribution is often problematic for derivative instruments such as options. Unlike linear assets, the returns of options are typically highly skewed due to their non-linear payoff structures and limited liability. Because the bell curve is symmetric, it fails to accurately represent the asymmetric risk profiles and potential for large, lopsided losses inherent in options.

15. (D) Assertion (A) is false, but Reason (R) is true.
The square root of time scaling method relies on the assumption that daily price movements are independent, with no autocorrelation or mean reversion. This technical justification is theoretically sound. However, the assertion that this approach can be extrapolated indefinitely without limits is incorrect, as these assumptions often fail to hold true in real markets over longer time horizons.

16. (A) (III), (IV), (I), (II)
Modern risk management began with Harry Markowitz's foundational work in the mid-twentieth century. Later, major financial institutions developed internal models for measuring aggregated risks. This led to the specific request for a daily risk report by the chairman of JP Morgan. Ultimately, the methodology was made public to outside parties, facilitating widespread adoption of standardized risk metrics.

17. (A) (I), (II), (III), (IV), and (V)
Computing Value at Risk involves several critical steps to ensure accuracy and relevance. These include setting the appropriate confidence level and time horizon based on institutional needs. Additionally, risk managers must compute the mark-to-market position of the portfolio, measure the variability or standard deviation of risk factors, and finally report the worst potential loss to the relevant stakeholders.

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52. (D) P-1, Q-3, R-2, S-4
The parametric method is less accurate for nonlinear portfolios. Historical simulation is difficult to scale into the distant future without strong assumptions. Monte Carlo simulation only quantifies fat-tailed risk if scenarios are generated from appropriate distributions. Finally, all three approaches are vulnerable to regime shifts or sudden changes in market behavior that deviate from the model's underlying data.

53. (C) Statistical theory analyzing probability distribution "tails" to capture risk in extreme circumstances.
Extreme Value Theory is a specialized statistical framework used in risk management to analyze the tails of a probability distribution. Its goal is to capture and quantify risk in extreme circumstances that fall outside the range of normal market fluctuations. By focusing on these outliers, it provides a mathematical approach to attaching probabilities to the results of extreme stress scenarios.

54. (C) Compare realized trading results with model-generated risk measures to evaluate new models and reassess existing ones.
Back testing involves comparing realized trading results with the risk measures generated by a model. This process allows institutions to evaluate the effectiveness of new models and reassess existing ones based on empirical evidence. It is a critical component of the regulatory framework, ensuring that the internal models used for capital requirements remain accurate and reliable over time.

55. (A) (I), (II), (III), (IV), and (V)
High-quality stress tests must be relevant to current positions and examine potential regime shifts in the market. They should consider changes in all relevant market rates and account for market illiquidity. Additionally, good tests consider the complex interplay between market and credit risk, providing a comprehensive assessment of how extreme events might impact the institution across different risk categories.

56. (A) Monte Carlo generates random hypothetical scenarios, while Historical Simulation takes actual past market movements as scenarios.
The fundamental difference between these two methods lies in how they generate potential market scenarios. Monte Carlo simulation uses random numbers to create a large set of hypothetical future scenarios based on specified parameters. In contrast, Historical Simulation uses actual past market movements as the basis for its scenarios, effectively replaying history to see how the current portfolio would have performed.

57. (A) Develop a robust risk profile, evaluate limitations, and improve fundamental assumptions.
The combined deployment of Value at Risk, stress testing, and back testing is intended to develop a robust institutional risk profile. This comprehensive approach allows firms to evaluate the limitations of their models, identify where fundamental assumptions may be failing, and continuously improve their risk management frameworks. It provides a more complete view of risk than any single tool used in isolation.

58. (A) Normal distribution
The basic parametric approach to calculating Value at Risk implicitly assumes that asset returns follow a normal distribution. This bell-shaped curve does not adequately account for the "fat tails" observed in real financial markets, where extreme price movements occur more frequently than the model predicts. Consequently, this methodology often underestimates potential losses during severe market shocks or periods of high volatility.

59. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Results from stress tests are typically expressed as changes in the present value of a portfolio rather than changes in Value at Risk. This occurs because the process of stress testing involves revaluing the portfolio by marking all financial instruments to market under new, worst-case market rates. This direct revaluation provides a clear picture of the immediate economic loss.

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specifically on the impact of market price changes on a portfolio's value.

27. (A) ₹ 4,112,500 × 4.58
To extrapolate a one-day Value at Risk to a longer time horizon, the square root of time rule is applied. For a monthly horizon of twenty-one trading days, the daily value must be multiplied by the square root of twenty-one. Since the square root of twenty-one is approximately four point five eight, the calculation uses this specific multiplier.

28. (A) Cash flow at risk
For nonfinancial corporations concerned with currency swings and potential liquidity crises, Cash Flow at Risk is the most appropriate application of the risk measurement framework. This specific approach helps managers determine the likelihood of a critical shortfall in available funds. It allows the institution to centralize its risk management and prepare for adverse movements in multiple currencies.

29. (C) Likelihood questions specify the quantity to find the associated probability, while quantile questions use probability to find the associated amount.
Likelihood questions and quantile questions approach the normal distribution from opposite directions. A likelihood question specifies a particular value or quantity to determine the associated probability of its occurrence. Conversely, a quantile question starts with a target probability, such as ninety-five percent, to find the corresponding cutoff value or amount that represents that specific point in the distribution.

30. (D) Liquidation period - The time required to liquidate a portfolio or to hedge the market risks.
The liquidation period is a fundamental component of the Value at Risk framework. It represents the estimated time required to either liquidate a portfolio entirely or to effectively hedge its market risks. This period directly informs the choice of the time horizon, ensuring that the risk measure reflects the reality of how quickly an institution can exit its positions.

31. (C) It is definitively less accurate for nonlinear portfolios compared to the parametric method.
Monte Carlo simulation is highly regarded for its ability to handle complex, non-linear portfolios more accurately than the parametric method. While it is computationally intensive, requires significant time, and necessitates the revaluation of portfolios under many scenarios, its flexibility in modeling non-linear payoffs is a primary strength. Therefore, suggesting it is definitively less accurate for such portfolios is incorrect.

32. (B) Introducing market shocks.
Stress testing through market shocks involves moving specific risk factors in isolation by large, predetermined amounts. This technique allows risk managers to gauge the portfolio's sensitivity to individual variables. It differs from historical scenarios or anticipatory scenarios by focusing on hypothetical, extreme changes in single factors rather than consistent movements across all relevant global market rates simultaneously.

33. (B) (I), (II), and (III)
The Monte Carlo simulation process begins with identifying all relevant risk factors and their dynamics, such as volatilities and correlations. Next, the model constructs various time paths by simulating market movements over smaller intervals. Finally, this construction is repeated a large number of times to generate a distribution of potential outcomes, providing a robust measure of portfolio risk.

34. (D) The integrity of position and market data, methodology, and model parameters.
When a Value at Risk model consistently fails to predict losses within specified confidence bands, the risk management team must investigate technical and procedural causes. This involves checking the integrity of position and market data, evaluating the underlying methodology, and reassessing model parameters. These elements are the primary drivers of model accuracy, unlike physical security or unrelated budgets.

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35. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
Extreme Value Theory is based on the mathematical principle that the tails of fat-tailed distributions converge to the Pareto distribution. This allows for more accurate modeling of extreme events. While it is also true that EVT involves estimating the conditional distribution of excesses beyond a high threshold, this procedural detail does not serve as the explanation for the convergence.

36. (A) (I), (II), and (III)
A ninety-five percent daily VaR implies that losses will exceed the limit on approximately five out of every one hundred days. Regulatory standards, such as those from the Basel Committee, often require measuring market risk over a ten-day horizon. The parametric method is designed to predict losses effectively under normal conditions. However, daily VaR cannot be scaled simply by multiplication.

37. (C) The 6~th largest loss
In a historical simulation using one hundred data points, a ninety-five percent confidence level implies that five percent of the observations fall into the tail. This means the five largest losses are exceeded by the Value at Risk threshold. Therefore, the sixth largest loss from the bottom serves as the actual cutoff point that represents the ninety-five percent VaR estimate.

38. (D) Aggregating scenarios from individual risk takers for cross-firm analysis of diversification or exacerbation.
A bottom-up approach to stress testing involves aggregating scenarios generated by individual risk takers and business units across the entire firm. This method allows senior management to analyze how different positions might diversify or exacerbate each other during a crisis. It provides a granular view of risk that starts at the desk level before being consolidated firm-wide.

39. (D) Indirect loss / longer-term indirect effects on a firm's well-being.
When a risk manager considers the structural decrease in demand for services, such as equity underwriting, alongside direct trading losses, they are assessing indirect effects. These longer-term impacts on a firm's well-being go beyond immediate mark-to-market changes. Such analysis is crucial for understanding the full impact of a prolonged market downturn on the institution's overall business model and profitability.

40. (B) Models may be based on inappropriate assumptions regarding market behavior or distributions.
Model risk in Value at Risk estimations primarily arises when the underlying models are based on inappropriate assumptions regarding market behavior or the statistical distribution of returns. If a model assumes normality while the actual market exhibits fat tails, the risk estimates will be flawed. This mismatch between theoretical assumptions and market reality leads to significant underestimation of losses.

41. (C) Model risk originating from inaccurate parameter estimations or flawed assumptions.
Monte Carlo simulations are highly sensitive to the parameters and assumptions provided by the analyst, such as mean reversion factors and volatilities. If these inputs are incorrectly estimated or flawed, the resulting risk output will be inaccurate. This specific vulnerability is a form of model risk, where the failure originates from the design and parameterization of the mathematical simulation itself.

42. (C) It estimates VaR with an equation that specifies parameters such as volatility, correlation, delta, and gamma.
The parametric method for calculating Value at Risk uses an equation based on specific statistical parameters. These typically include the standard deviation or volatility, correlations between assets, and sensitivity measures like delta and gamma. By assuming a specific distribution, such as the normal distribution, it allows for a mathematically straightforward calculation of risk without needing to simulate every future scenario.

43. (B) Generate scenarios
The process of stress testing begins with the generation of scenarios. These scenarios

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represent extreme but plausible market events that could significantly impact the portfolio's value. Once these scenarios are defined, the subsequent steps include revaluing the portfolio under these new conditions and then summarizing the results to provide an overview of potential economic losses in abnormal markets.

44. (B) EVT cannot accommodate skewed and fat-tailed distributions, making it essentially identical to the basic parametric approach.
Extreme Value Theory is specifically designed to accommodate skewed and fat-tailed distributions, which distinguishes it from the basic parametric approach that assumes normality. It focuses on the tails of the distribution to capture risk in extreme circumstances. Suggesting that it cannot handle these distributions is incorrect, as its primary utility lies in modeling the behavior of extreme outliers.

45. (C) P-2, Q-1, R-4, S-3
Confidence levels are percentages indicating the probability that actual losses will not exceed the risk estimate. Historical simulation uses actual past data to assess market impacts. Monte Carlo simulation generates random hypothetical scenarios to model potential outcomes. Finally, Value at Risk represents the predicted worst-case loss at a specific confidence level over a set period under normal conditions.

46. (B) ₹ 464,000
In a historical simulation with one hundred data points, the ninety-five percent confidence level is represented by the sixth largest loss. If this loss is observed as four point six four percent, the Value at Risk is calculated by multiplying the portfolio's total value of ten million by this percentage. This results in a calculated risk amount of four hundred sixty-four thousand.

47. (B) Primary function of back testing - Correcting the past historical data points directly to perfectly match the theoretical model.
The primary function of back testing is to evaluate the performance of a risk model by comparing predicted results with actual trading outcomes. It is not intended to change or correct historical data points to fit a theoretical model. Instead, it serves as a diagnostic tool to identify model weaknesses, data integrity issues, or inappropriate assumptions that require adjustment.

48. (B) Historical simulation
Historical simulation is the most suitable methodology for a portfolio with non-linear derivatives and skewed instruments when the user wants to avoid distributional assumptions. By relying on actual historical rate history, it inherently captures the empirical characteristics of market movements. This approach does not require parameter fitting or a commitment to a specific probability curve, unlike parametric methods.

49. (A) P-2, Q-3, R-1, S-4
Generating scenarios involves addressing both the magnitude of market movements and their interrelationships. Revaluing the portfolio means marking all instruments to market under worst-case rates. Summarizing results highlights where business area losses would be concentrated. Creating anticipatory scenarios moves multiple market factors consistently to approximate real-world market shifts, providing a comprehensive view of potential systemic risks.

50. (C) (I), (II), and (IV)
Stress tests are designed to estimate potential economic losses in abnormal markets and enhance transparency by exploring low-probability, high-impact events. They answer questions about how much might be lost under specific extreme scenarios. However, they do not replace Value at Risk, which remains the primary benchmark for measuring risk under standard daily normal trading conditions within financial institutions.

51. (B) ₹ 2.24 million
To convert a one-day Value at Risk to a five-day horizon, the square root of time scaling method is used. This involves multiplying the daily VaR of one million by the square root of five. Since the square root of five is approximately two point two four, the resulting five-day Value at Risk is reported as two point two four million.

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true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2014

6. The strategic approach of the operational risk management function should be oriented towards which of the following?
I Minimizing losses and customer dissatisfaction due to process failures.
II Focusing on product flaws that expose the institution to fraud.
III Maximizing conflicts between employees and the institution to foster competitive drive.
IV Analyzing the impact of technology failures and developing mitigants.
V Developing plans for external shocks to ensure continuity of operations.
Which of the above statement(s) is/are correct?
(A) (I), (II), (IV), and (V) only
(B) (I), (II), (III), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (II), (III), (IV), and (V) only

Oct/Nov 2022

7. Which of the following best defines the scope of operational risk?
(A) The risk of loss resulting from market fluctuations and credit defaults, including strategic and reputational risk.
(B) The risk of loss from failed processes, people, systems, or external events, including legal risk but excluding strategic risk.
(C) The risk of loss arising from macroeconomic variables and strategic business decisions, excluding legal risk and compliance.
(D) The risk of loss due to technological failures and outsourcing dependencies, including reputational risk and market variables.

May/June 2005

8. There are eight business lines typically identified for operational risk capital charges. Which of the following is an INCORRECT pair of a broad activity and its corresponding business line?
(A) Trust and estates - Agency Services
(B) Private lending and deposits - Corporate Finance
(C) Merchant/commercial/corporate cards - Retail Banking
(D) Sale-purchase of securities and currencies - Trading and Sales

Oct/Nov 2011

9. Which of the following statements about the identification of operational risk events is incorrect?
(A) An operational risk event is an incident that has caused or has the potential to cause material loss to a bank.
(B) Operational risk events can arise from people, process, and systems failures, but exclude events from external causes.
(C) Risk events can be listed from adverse incidents that have taken place in the past in branch offices or controlling offices.
(D) It is necessary to separate operational risk and operations risk to treat them appropriately.

May/June 2017

10. Consider the following statements regarding the Risk Management Committee of the Board (RMCB):
I It determines what risk management matters related to operational risk have to be reported to the full Board of Directors.
II It is responsible for approving the operational risk capital methodology and the resulting attribution.
III It functions as an executive committee focused principally on the day-to-day mitigation of operational risk within the institution.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2016

11. Based on the Top-Down Approach for operational risk mapping, arrange the following phases in the correct sequence from top to bottom:
I Identification of products

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60. (A) Both (I) and (II) are correct.
Risk management requires modeling different parts of the return distribution depending on the position held. A long position is vulnerable to negative returns, so it focuses on the lower tail of the distribution. Conversely, a short position suffers losses when prices rise, requiring the holder to focus on the upper tail of the distribution to capture potential extreme losses.

61. (C) Regime shifts or sudden unprecedented changes in market behavior.
All Value at Risk methodologies are vulnerable to regime shifts, which are sudden and unprecedented changes in market behavior. When a central bank's intervention causes a massive devaluation not reflected in historical data, the models fail to capture the magnitude of the risk. This highlights that risk metrics based on past behavior cannot easily predict structural breaks or unique market crises.

62. (A) A strict 10-day historical data limit to avoid computational over-processing.
Monte Carlo simulations require various assumptions about market dynamics, such as correlations between risk factors, current volatility measures, and mean reversion factors for interest rates. However, there is no strict requirement for a ten-day historical data limit. In fact, more data is generally preferred to refine the parameters used to generate the random scenarios that drive the simulation's results.

63. (C) Presence of fat tails where extreme market moves occur more frequently than normal distributions suggest.
Leptokurtosis refers to a statistical property of a distribution where there is a high concentration of data around the mean and in the tails. In financial markets, this indicates the presence of fat tails, meaning that extreme market moves occur more frequently than what is suggested by a normal distribution. Recognizing this phenomenon is crucial for accurate risk measurement and management.

64. (C) Quantile questions specify the probability to ask about the probability amount instead of the cutoff value.
Quantile questions do not ask about the probability amount; rather, they specify a probability to identify a specific cutoff value or quantile. Conversely, likelihood questions use a specified amount to determine the probability of that event occurring. A probability density function provides a full representation of outcomes, and the normal curve's shape is determined by the mean and deviation.

65. (B) Both Statement (I) and Statement (II) are correct.
The parametric method is efficient because it requires only a volatility and correlation matrix rather than extensive historical data. In contrast, historical simulation necessitates a significant amount of daily rate history to produce reliable results. Monte Carlo simulation does not strictly require a five hundred-day unadjusted replica; instead, it uses parameters to generate entirely random hypothetical scenarios.

66. (D) It provides a full distribution of potential portfolio values rather than just a specific percentile limit.
The parametric method typically provides a specific percentile limit representing the Value at Risk rather than a full distribution of all potential portfolio values. While it offers fast calculations using a volatility and correlation matrix, its reliance on the normal distribution assumption makes it less accurate for non-linear portfolios and incapable of describing the entire range of extreme potential outcomes.

67. (D) Formalize that the probability of loss L exceeding VaR is less than or equal to $1 - c$.
The general mathematical formulation for Value at Risk formalizes the relationship between a potential loss and a chosen confidence level. It states that the probability of the actual loss being greater than the calculated VaR threshold is less than or equal to one minus the confidence level. This defines VaR as a statistical limit on losses for a given probability.

68. (A) P-2, Q-1, R-3, S-4
In the risk framework, p is the probability measure between zero and one. c represents the

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confidence level used in the general definition. z is the standard score used to transform normal random variables based on the mean and standard deviation. Finally, α is the quantile representing a cutoff value where the area represents a specific probability of loss.

69. (B) (I), (II), (III), (IV), and (V)
Value at Risk is utilized across the financial spectrum for diverse purposes. Banks use it for position limits and capital, while corporations apply it to cash flows. Asset managers assess portfolio capital, and sovereign users evaluate currency liabilities and hedging. Finally, regulators use VaR as a benchmark for determining minimum capital requirements under the internal models approach for market risk.

70. (B) It requires one incident per 10,000 days (approx. 40 years), making verification data unfeasible to collect.
Verifying a Value at Risk model at a ninety-nine point nine nine percent confidence level is practically impossible through back testing. This level implies only one incident of loss exceeding the VaR every ten thousand trading days, which is approximately forty years. Collecting enough statistically significant historical data to verify such an infrequent occurrence is unfeasible for most financial institutions.

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CHAPTER 17

Operational Risk and Operational Risk Management Framework

Oct/Nov 2014

1. What is the most critical element for the successful implementation of an operational risk framework across a banking institution?

(A) The exclusive reliance on external consultants for identifying and mitigating potential operational risk events.

(B) The implementation of the most sophisticated highly automated technology to replace manual transaction processing.

(C) The delegation of all operational risk monitoring strictly to the internal audit department for oversight.

(D) An enabling culture led by the Board and senior management through an energized organizational change programme.

May/June 2023

2. On which date were the revised regulatory guidelines on Operational Risk Management and Operational Resilience released, aligning with international principles issued in March 2021?

(A) October 14, 2005

(B) June 26, 2023

(C) April 1, 2024

(D) April 30, 2024

Oct/Nov 2006

3. How does operational risk fundamentally differ from market and credit risk in the context of financial intermediaries?

(A) Operational risk is directly taken in return for an expected reward, whereas market and credit risks are inherent in corporate activity.

(B) Operational risk arises only when a firm decides to do business with a specific counterparty, unlike market risk.

(C) Operational risk is omnipresent in business activities and typically not directly taken in return for an expected reward.

(D) Operational risk is easily collateralized and has well-defined boundaries compared to market and credit risks.

May/June 2019

4. Consider the following statements regarding the approaches for operational risk identification:

Statement I: The top-down approach begins at the senior management level, looking at large exposures and breaking the bank's activities down into business lines.

Statement II: The bottom-up approach collects data on individual risk events, classifies them, and aggregates them to provide a comprehensive picture of operational risk.

Which of the following is correct?

(A) Both Statement I and Statement II are true.

(B) Both Statement I and Statement II are false.

(C) Statement I is true, and Statement II is false.

(D) Statement I is false, and Statement II is true.

Oct/Nov 2010

5. Given below are two statements, one labeled as Assertion (A) and the other labeled as Reason (R). Select the correct answer from the options provided.

Assertion (A): The Operational Risk Management Department (ORMD) will work closely with Internal Audit to share information and coordinate activities.

Reason (R): Sharing information and coordinating activities ensures that the ORMD can directly dictate the internal audit schedule to minimize potential overlap of activities.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are

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18. (A) Both (I) and (II) are correct.
The mathematical definition of Value at Risk uses the change in the value of a position over a specific horizon. This change is denoted by the difference between the future value and the current value. The resulting identity establishes that the probability of the negative change in value being greater than the threshold equals the specified probability.

19. (D) Small standard deviation - The resulting curve is short and wide.
In a normal distribution, the standard deviation dictates the shape of the bell curve. A large standard deviation results in a distribution that is shorter and wider, reflecting higher volatility. Conversely, a small standard deviation creates a curve that is taller and narrower, indicating that the data points are clustered closely around the mean of the distribution.

20. (A) (I), (II), and (IV)
Selecting an appropriate confidence level for risk calculations depends on several institutional factors. These include the degree of risk aversion within the company and the potential costs associated with a loss exceeding the estimated value. Furthermore, institutions consider the need to avoid bankruptcy. The physical liquidation period typically influences the time horizon rather than the specific confidence level.

21. (C) It accommodates linear or non-linear portfolios without assuming a specific distribution of price changes.
A major advantage of the historical simulation approach is its flexibility across different portfolio types. It can accommodate both linear and non-linear instruments, such as options, without requiring the assumption of a specific probability distribution for price changes. By using actual past market movements, it captures the real empirical characteristics of market data, including skewness and heavy tails.

22. (B) There is a 1% chance that the loss will be greater than ₹ 200,000.
Value at Risk provides a statistical boundary for potential losses based on a chosen confidence level. A ninety-nine percent daily VaR of two hundred thousand means that there is a one percent probability that the actual loss on any given day will exceed this amount. It does not cap the maximum possible loss nor define the most likely outcome.

NODIA

23. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Sovereign entities use Value at Risk analysis to manage national debt and currency exposures. By identifying potentially dangerous financial scenarios, this analysis encourages countries to consider lengthening debt maturities or hedging foreign currency liabilities. This proactive approach helps reduce overall risk levels by forcing policy makers to confront the statistical likelihood of adverse market movements.

24. (D) $z = \frac{(X - \mu)}{\sigma}$
The standard score, or z-score, is a mathematical tool used to determine how many standard deviations a data point is from the mean. It is calculated by subtracting the mean of the distribution from the individual observation and then dividing the resulting difference by the standard deviation. This transformation allows for comparison across different normal distributions by standardizing them.

25. (B) 1-day horizon for the trading desk; 1-year horizon for the credit portfolio.
The choice of a time horizon for risk measurement depends on the liquidity and turnover of the underlying assets. For a trading desk dealing with highly liquid securities, a one-day horizon is appropriate to capture rapid price changes. In contrast, credit portfolios containing illiquid corporate bonds require a much longer horizon, such as one year, to reflect their holding period.

26. (D) Potential loss from unexpected volatility in asset, equity, or earnings value.
Market risk is fundamentally defined as the potential for financial loss resulting from unexpected volatility in the value of assets, equities, or earnings. This uncertainty arises from movements in market factors such as interest rates, exchange rates, and stock prices. Unlike credit or operational risk, it focuses

II Identification of business lines
III Identification of risk events
IV Identification of activity groups
(A) (II), (IV), (I), (III)
(B) (II), (I), (IV), (III)
(C) (IV), (II), (I), (III)
(D) (I), (II), (IV), (III)

May/June 2021

12. Which of the following statements regarding the categories of operational risk is incorrect?
(A) People risk encompasses the inability to attract, manage, motivate, develop, and retain competent resources.
(B) Process risk includes product design flaws and internal project failures within every aspect of the business.
(C) Systems risk encompasses natural disasters such as hurricanes, earthquakes, and civil disruptions.
(D) Legal and compliance risk includes non-compliance with anti-money laundering requirements and tax laws.

Oct/Nov 2009

13. In the context of operational risk cause and effect analysis, which of the following best describes the "System/Technology" cause category?
(A) The risk resulting from inadequate or failed system infrastructure, including obsolete applications and poor design.
(B) The risk resulting from business volume fluctuation, organizational complexity, and major changes in the environment.
(C) The risk resulting from deliberate or unintentional actions, inadequate training, or inappropriate treatment of employees.
(D) The risk resulting from inadequate segregation of duties, lack of management supervision, and failed internal controls.

May/June 2018

14. Arrange the following steps of the operational risk identification process in the correct sequential order:
I Identify products used by the product team in each business line.
II List operational risk events associated with the products.
III Identify the business line.
IV Identify the product team in each business line.
(A) (III), (IV), (I), (II)
(B) (III), (I), (IV), (II)
(C) (IV), (III), (I), (II)
(D) (I), (II), (III), (IV)

Oct/Nov 2024

15. Which of the following are examples of "Execution, delivery and process management" operational risk events?
I Data entry errors
II Collateral management failures
III Vendor disputes
IV Hardware and software failures
Which combination is correct?
(A) (I), (II), and (III) only
(B) (I), (II), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

May/June 2010

16. Which of the following developments is primarily associated with the transformation of risks from manual processing errors to system failure risks?
(A) Greater use of highly automated technology
(B) High economic growth in developing economies
(C) Outsourcing of financial and nonfinancial services
(D) Large-scale acquisitions and consolidations

Oct/Nov 2005

17. What is the primary purpose of utilizing Key Risk Indicators (KRIs) within a bank's operational risk assessment framework?
(A) To act as statistical metrics, often reviewed periodically, to alert the bank to changes indicative of risk concerns.
(B) To provide a definitive calculation of the exact regulatory capital required for market risk.
(C) To translate qualitative employee feedback into performance bonuses for line managers.
(D) To map organizational functions or process flows by credit risk type to determine insurance premiums.

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NODIA

Oct/Nov 2011

51. Which of the following statements accurately summarizes the nature of operational risk as opposed to market risk?

(A) Operational risk can be completely eliminated through the implementation of standardized core banking systems.

(B) Operational risk is intentionally taken by a firm to generate alpha and maximize shareholder expected returns.

(C) Operational risk strictly arises post-transaction and never during the transaction negotiation stage of a deal.

(D) Operational risk is not directly taken in return for an expected reward and is often difficult to collateralize.

May/June 2017

52. The risk of financial losses and negative social performance related to non-compliance with anti-money laundering (AML) requirements, tax laws, and human resource laws is precisely defined as:

(A) Strategic and Reputational Risk

(B) External Events Risk

(C) Systems Risk

(D) Legal and Compliance Risk

Oct/Nov 2016

53. The Operational Risk Management policy of a bank should be documented and outline several aspects. Which of the following is NOT an explicit requirement to be included in the policy?

(A) The firm's definition of operational risk, including the loss event types that will be monitored.

(B) A description of the internally derived analytical framework that quantifies operational risk exposure.

(C) A mandate to align the operational risk framework seamlessly with the bank's marketing and public relations campaign strategies.

(D) Define the risk tolerance level for the bank, break it down to appropriate sub-limits, and prescribe reporting levels.

May/June 2021

54. Read the following scenario and identify the correct business line mapping:

Alpha Bank operates a specialized desk that solely handles the execution of trades and the management of sales for corporate securities and foreign exchange. According to the business lines prescribed for operational risk capital charges, the activities of this desk should be mapped to which business line?

(A) Corporate Finance

(B) Commercial Banking

(C) Trading and Sales

(D) Retail Brokerage

Oct/Nov 2009

55. Given below are two statements, one labeled as Assertion (A) and the other labeled as Reason (R). Select the correct answer from the options provided.

Assertion (A): The internal audit function must be structurally separated and not directly involved in the operational risk processes.

Reason (R): Strong internal controls require a separation of responsibilities for reporting lines between operational risk control functions, business lines, and support functions to avoid conflict of interest.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

May/June 2018

56. Read the following scenario and identify the specific activity of the Operational Risk Management Department (ORMD) being exercised:

Zenith Bank has recently observed an increasing trend in low-frequency, high-severity operational risk losses stemming from advanced cyber-attacks. The bank's ORMD decides to transfer a portion of this financial impact rather than absorbing it entirely through capital allocation.

(A) Working with the bank's insurance area to determine optimal insurance limits and coverage.

(B) Systematic consolidation and reporting of historical loss data for senior management

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II Designing, collecting, reporting, and data capture of risk indicators.
III Coordinating collection, recording, and data capture of loss events.
IV Timely follow-up and documentation of open issues from Internal Audit and Regulators.
V Independently auditing the operational risk management processes for regulatory compliance.

Which of the above statement(s) accurately reflect the responsibilities of the Operational Risk Liaisons?
(A) (I), (II), (III), and (V) only
(B) (I), (II), IV), and (V) only
(C) (I), (II), (III), and (IV) only
(D) (II), (III), (IV), and (V) only

May/June 2013

24. Which of the following is NOT typically considered a consequence or "Effect" of an operational risk event as per the cause and effect analysis?
(A) Financial asset write-downs
(B) Monetary restitution payments
(C) Direct loss of recourse
(D) Inadequate segregation of duties

Oct/Nov 2019

25. Based on the following scenario, identify the associated risk development:
Horizon Bank has recently outsourced the maintenance of its automated teller machines and the transportation of cash to a third-party logistics firm, SecureTransit. During a festive season, SecureTransit's workforce went on a sudden strike, leading to cash shortages across 30% of Horizon Bank's ATMs for three days. The bank faced intense customer dissatisfaction and negative media coverage. In the context of operational risk developments, this scenario best highlights the risk associated with:
(A) High economic growth testing the viability of integrated systems.
(B) Outsourcing, specifically the non-availability of services in emergency situations.
(C) The emergence of e-commerce bringing internal fraud and system security issues.
(D) Highly automated technology transforming risks to system failure risks.

May/June 2016

26. Which of the following statements correctly highlights the timeline of operational risk in a banking transaction?
(A) Operational risk only emerges during the transaction processing stage when programming or systems errors may occur.
(B) Operational risk is strictly confined to the product delivery stage involving the risk of misuse of financial powers by staff.
(C) Operational risk ceases to exist as soon as the transaction is closed and the customer relationship is formally terminated.
(D) Operational risk commences before transactions are executed, continues during delivery, and remains after completion.

Oct/Nov 2007

27. Consider the following statements regarding modern operational risk management and operational resilience frameworks:
I The focus has shifted from merely managing risk to achieving operational resilience as an outcome.
II The applicability of these standards is strictly limited to Scheduled Commercial Banks.
III Certain approaches for operational risk capital calculation have been dropped for entities like Small Finance Banks and Payments Banks.

Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

May/June 2025

28. Consider the following key roles of the Operational Risk Management Committee (ORMC):
I Review the risk profile and concur on areas of highest priority related mitigation strategy.
II Assure adequate resources are assigned to mitigate risks as needed.
III Set and approve expressions of risk appetite within overall parameters set by the Board.
IV Study the risk profile of new products and recommend/not recommend the product

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to RMCB under the 'New Product Approval Process'.

Which of the above statement(s) correctly represent the roles of the ORMC?

(A) (I), (II), and (IV) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2018

29. Which of the following statements is correct regarding the Operational Risk Management policy requirements for banks?

(A) The operational risk management policy requires approval from the business line managers and should be confidential to top management.
(B) The policy is standardized across all financial institutions regardless of the scale and materiality of the risk present.
(C) The policy must outline the roles of the independent bank-wide ORM function and line of business management.
(D) The policy should mandate the complete elimination of operational risk events within the first operational quarter.

May/June 2022

30. Match the following operational risk event types with their corresponding examples:

List I: Event Types
P. Internal fraud
Q. External fraud
R. Employment practices and workplace safety
S. Clients, products, and business practices

List II: Examples
1. Fiduciary breaches and misuse of confidential customer information
2. Workers compensation claims and diversity/discrimination events
3. Robbery, forgery, and damage from computer hacking by a third party
4. Intentional misreporting of positions and insider trading

(A) P-4, Q-3, R-2, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-4, Q-2, R-3, S-1
(D) P-1, Q-3, R-2, S-4

Oct/Nov 2017

31. Which of the following is NOT one of the eight standard business lines suggested for the calculation of operational risk capital charges under the Standardized Approach?

(A) Corporate Finance
(B) Payment and Settlement
(C) Strategic Investments
(D) Agency Services

May/June 2024

32. Based on the scenario described, answer the following question:

A coordinated cyber-attack by an anonymous hacker group successfully breached the firewall of Global Trust Bank, leading to the unauthorized transfer of funds from several corporate accounts and severe damage to the bank's core database. The event was orchestrated entirely by third parties outside the bank. This incident is an example of which operational risk event type?

(A) Business disruption and system failures
(B) External fraud
(C) Internal fraud
(D) Clients, products, and business practices

Oct/Nov 2013

33. Which of the following pairs concerning the assessment of operational risk is INCORRECT?

(A) Self-Risk Assessment - Incorporates checklists and/or workshops to identify strengths and weaknesses.
(B) Risk Mapping - Translating qualitative assessments into quantitative metrics using scorecards.
(C) Key Risk Indicators - Metrics such as staff turnover rates and frequency of errors reviewed periodically.
(D) External Consultants - Engaged for identification of minutest risks that might be missed internally.

NODIA

May/June 2009

34. Read the following scenario and identify the committee responsible for the process:

Silver Oak Bank plans to launch a novel synthetic derivative product linked to carbon credits. Before its market rollout, the proposal is sent to a specific executive committee to study its risk profile, review its mitigation process against business potentials, and provide a

formal recommendation to the RMCB. Which committee is fulfilling this 'New Product Approval Process' role?
(A) Board of Directors
(B) Audit Committee
(C) Risk Management Committee of the Board (RMCB)
(D) Operational Risk Management Committee (ORMC)

Oct/Nov 2008

35. Why is it essential for banks to meticulously separate "operational risk" from "operations risk" during the identification phase?
(A) To ensure that both types of risks are treated appropriately according to their unique characteristics and underlying causes.
(B) Because operations risk solely deals with external natural disasters, while operational risk deals with internal frauds.
(C) Because operational risk is a subset of credit risk, while operations risk is a subset of market risk.
(D) To allow the bank to bypass capital charge calculations for operations risk while focusing on credit risk modeling.

May/June 2011

36. When a bank develops its operational risk management strategy, how should it approach the implementation of risk mitigants according to policy guidelines?
(A) Decide upon mitigants rationally by looking at the costs of putting in mitigants against the benefit of reducing operational losses.
(B) Implement all available mitigants regardless of financial cost to ensure a strictly zero-risk environment.
(C) Focus entirely on customer incentive systems rather than technological mitigants to drive growth.
(D) Defer the implementation of mitigants until an actual external shock impacts the institution's core operations.

Oct/Nov 2012

37. Match the organizational entities with their primary operational risk responsibilities:
List I: Organizational Entities
P. Board of Directors
Q. Risk Management Committee of the Board (RMCB)
R. Operational Risk Management Committee (ORMC)
S. Operational Risk Liaisons
List II: Primary Responsibilities
1. Execute the mitigation of operational risk through the creation and maintenance of an explicit ORM process
2. Coordinate collection, recording, and data capture of loss events within the businesses
3. Approve an appropriate operational risk management framework for the bank and review it periodically
4. Approve operational risk capital methodology and the resulting attribution
(A) P-3, Q-4, R-1, S-2
(B) P-4, Q-3, R-2, S-1
(C) P-3, Q-1, R-4, S-2
(D) P-1, Q-4, R-3, S-2

May/June 2015

38. The Operational Risk Organizational Framework involves multiple layers. Which of the following responsibilities rest with the Risk Management Committee of the Board (RMCB)?
I Approve operational risk policies and investments.
II Decide what needs Board approval and forward it appropriately.
III Review profiles of operational risk throughout the organization.
IV Approve operational risk capital methodology.
V Facilitate periodic self-assessments at the unit level.
Which combination is correct?
(A) (I), (II), (III), and (IV) only
(B) (II), (III), (IV), and (V) only
(C) (I), (II), (IV), and (V) only
(D) (I), (III), (IV), and (V) only

Oct/Nov 2023

39. Read the following scenario and determine the classification of the risk event:
During a routine expansion, Northern Bank terminated several employees from its legacy systems division. The terminated employees subsequently filed a massive class-action lawsuit against the bank, claiming discriminatory

NODIA

May/June 2012

18. Consider the following statements regarding the organizational set-up for operational risk management:
Statement I: The Board of Directors is primarily responsible for ensuring effective risk management of the bank as a whole, including managing operational risks.
Statement II: The internal audit function must be directly involved in the operational risk processes to ensure effective implementation of policies.
Which of the following is correct?
(A) Both Statement I and Statement II are true.
(B) Both Statement I and Statement II are false.
(C) Statement I is true, and Statement II is false.
(D) Statement I is false, and Statement II is true.

Oct/Nov 2021

19. In the 'Three lines of defence' model structured within regulated financial entities, how are the roles organized?
(A) The business unit forms the first line, the audit function forms the second line, and the ORM function forms the third line.
(B) The ORM function forms the first line, the business unit forms the second line, and the audit function forms the third line.
(C) The audit function forms the first line, the compliance function forms the second line, and the business unit forms the third line.
(D) The business unit forms the first line, the ORM function the second line, and the audit function the third line.

May/June 2007

20. Which of the following correctly pairs the Operational Risk Management Department's (ORMD) specific activity with its corresponding description?
(A) Best Practices - Identifying practices from within the bank or external sources to manage operational risk.
(B) Risk Indicators - Purchasing or developing tools that the Bank will use in its ORM programme.
(C) Consolidation of Data - Working with the bank's insurance area to determine optimal limits and coverage.
(D) Risk Mitigation - Drafting, presenting, and updating the Operational Risk Policy.

Oct/Nov 2015

21. Given below are two statements, one labeled as Assertion (A) and the other labeled as Reason (R). Select the correct answer from the options provided.
Assertion (A): Operational risk is omnipresent in a bank and is considered an inevitable and pure risk.
Reason (R): Operational risk arises immediately as soon as a firm has a single employee, a computer system, or a single process, unlike market risk which arises only when a firm deliberately decides to take on certain positions.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2020

22. Which of the following are identified as operational risk event types having the potential to result in substantial losses, EXCEPT:
(A) Internal fraud involving intentional misreporting of positions or employee theft.
(B) Changes in prevailing interest rates leading to a decline in the net interest margin.
(C) Damage to physical assets arising from terrorism, vandalism, earthquakes, and floods.
(D) Business disruption and system failures such as hardware, software, and telecommunication problems.

Oct/Nov 2025

23. The Organization-Wide Support Departments or Operational Risk Liaisons have several key responsibilities. Consider the following:
I Facilitating and verifying the results of the self-assessment process.

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Oct/Nov 2006

45. In modern banking risk management frameworks, the concept of 'outsourcing' is often updated to which broader terminology?
(A) Vendor Disruption Mapping
(B) External Interdependencies
(C) Third-party relationships
(D) Support Function Collaboration

May/June 2019

46. Which of the following accurately pairs the cause category of operational risk with its appropriate description?
(A) People - The risk resulting from external events outside the company's direct control.
(B) System/Technology - The risk resulting from inadequate or failed system infrastructure, obsolete applications, and poor design.
(C) Process oriented (Operational control based) causes - The risk resulting from business volume fluctuation and major changes.
(D) Process oriented (Transaction based) causes - The risk resulting from inadequate segregation of duties and lack of supervision.

Oct/Nov 2010

47. Read the following scenario and identify the applicable mapping principle:
A regional bank offers "Private Banking" services, which involves complex deposit schemes, bespoke lending, and specialized merchant cards. For the purpose of regulatory capital calculation for operational risk, the bank decides to group all these activities under "Retail Banking" as it is the most prominent supported business line. This decision is in alignment with which principle?
(A) Ignoring compound activities to minimize overall capital charge allocation for the institution.
(B) Assigning activities that belong to more than one business line to the most prominent or suitable business line.
(C) Mapping activities in a mutually inclusive and highly correlated manner to identify outliers.
(D) Avoiding the breakdown of business lines to bypass standardized approach requirements for capital.

May/June 2014

48. When mapping activities to business lines for the calculation of operational risk capital requirements, how should a bank treat an ancillary function of an activity?
(A) It must be mapped as a completely new, separate business line.
(B) It must be allocated to the specific business line that it supports.
(C) It should be allocated evenly across all eight standardized business lines to distribute the risk.
(D) It should be excluded from the operational risk framework and mapped under strategic risk.

NODIA

Oct/Nov 2022

49. Read the following scenario and identify the type of metrics used:
Metro Bank's operational risk manager notices a sharp 40% increase in staff turnover rates over the last quarter in the transaction processing unit, alongside a tripling in the frequency of data entry errors. To proactively address this issue before it leads to substantial financial loss, the manager flags these metrics in the monthly risk report. The metrics used by the manager are examples of:
(A) Key Risk Indicators
(B) Capital Measurement Models
(C) Self-Risk Assessments
(D) Risk Mapping techniques

May/June 2005

50. The increasing profile of operational risk in banks is driven by several evolving practices. Which of the following are cited as developments giving rise to increasing operational risk?
I Highly Automated Technology
II Emergence of E-Commerce
III Downsizing of organizations
IV Large-scale acquisitions and consolidations
Which combination is correct?
(A) (I), (II), and (III) only
(B) (I), (II), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

dismissal practices and seeking hefty workers' compensation. Under operational risk event types, this potential loss is categorized under:
(A) Legal and Compliance Risk
(B) Internal fraud
(C) Execution, delivery and process management
(D) Employment practices and workplace safety

May/June 2006

40. Regarding the introduction of new products by a bank, which statement correctly describes the responsibility of the Operational Risk Management Committee (ORMC)?
(A) The ORMC independently approves the launch of all new credit and market risk products without board oversight.
(B) The ORMC delegates the risk profiling of new products entirely to the internal audit department for review.
(C) The ORMC sets the pricing and marketing strategy for the new product to offset potential operational risks.
(D) The ORMC studies the risk profile of the new product and recommends it to the RMCB after reviewing mitigation processes.

Oct/Nov 2020

41. Which of the following statements regarding the Analysis of Data function of the Operational Risk Management Department (ORMD) is INCORRECT?
(A) ORMD is responsible for analyzing data on a consolidated basis.
(B) ORMD analyzes data strictly on a comparative basis, ignoring individual basis analysis.
(C) ORMD analyzes data on an individual basis.
(D) ORMD uses the analysis to communicate results to risk committees or other interested parties.

May/June 2008

42. Read the following scenario and determine the operational risk event type:
A relationship manager at Prime Capital Bank was found to have invested a wealthy client's funds into highly speculative derivatives without the client's explicit authorization, aiming to earn higher commissions. The client suffered heavy losses and sued the bank, citing a breach of fiduciary duty. Under which operational risk event type does this loss fall?
(A) Execution, delivery and process management
(B) Internal fraud
(C) Clients, products, and business practices
(D) Employment practices and workplace safety

Oct/Nov 2014

43. Read the following case study and identify the operational risk category:
In the aftermath of a severe Category 5 hurricane, Coastal Community Bank suffered extensive structural damage to three of its primary branches, destroying critical on-site hardware and physical document vaults. The bank had to completely reconstruct the branches. This specific operational risk event is best categorized as:
(A) Execution, delivery and process management
(B) Damage to physical assets
(C) Employment practices and workplace safety
(D) External fraud

May/June 2023

44. Consider the following statements regarding the Operational Risk Management Department (ORMD):
Statement I: ORMD is exclusively responsible for the development of the capital measurement methodology without any input from business areas.
Statement II: ORMD is responsible for the purchase or development and implementation of tools that the bank will use in its operational risk management programme.
Which of the following is correct?
(A) Both Statement I and Statement II are true.
(B) Both Statement I and Statement II are false.
(C) Statement I is true, and Statement II is false.
(D) Statement I is false, and Statement II is true.

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review.
(C) Adoption of best practices from international banking standards to improve resilience.
(D) Implementation of self-assessment processes across all functional units of the bank.

Oct/Nov 2024

57. The process wherein various business units, organizational functions, or process flows are geographically or structurally charted out by risk type to reveal areas of weakness and help prioritize subsequent management action is known as:
(A) Risk Mapping
(B) Cause and Effect Analysis
(C) Self-Risk Assessment
(D) Key Risk Indicators

May/June 2010

58. Which of the following statements about Organization-Wide Support Departments (Operational Risk Liaisons) is INCORRECT?
(A) The responsibility must always be assigned as a full-time position exclusively to a dedicated team of risk specialists.
(B) They are responsible for coordinating the management of operational risk within their specific business/functional area.
(C) They monitor the results of risk indicators and work with their respective departments on identified issues.
(D) They are responsible for the timely follow-up, documentation, and status of action plans for open audit issues.

Oct/Nov 2005

59. Match the cause categories of operational risk with their specific descriptors:
List I: Cause Categories
P. People
Q. Process oriented (Transaction based) causes
R. Process oriented (Operational control based) causes
S. External
List II: Descriptors
1. Inadequate segregation of duties and lack of management supervision
2. Deliberate or unintentional actions or treatment of employees
3. Natural disasters and operational failure of a third party
4. Business volume fluctuation and product complexity
(A) P-2, Q-4, R-1, S-3
(B) P-1, Q-4, R-2, S-3
(C) P-4, Q-2, R-3, S-1
(D) P-2, Q-1, R-4, S-3

May/June 2012

60. Consider the following statements about Operational Risk Assessment tools:
I Self-Risk Assessment is an internally driven process often incorporating workshops to identify strengths and weaknesses.
II Risk Mapping helps reveal areas of weakness by mapping various business units or process flows by risk type.
III Key Risk Indicators (KRIs) are qualitative surveys used solely to gauge employee morale and motivation.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

NODIA

Oct/Nov 2021

61. Read the following scenario and identify the risk event type:
An audit at Delta Commercial Bank revealed that a branch manager had been systematically misreporting the positions of certain high-value accounts over two years to circumvent company policy and embezzle funds for personal use. The event did not involve any third-party hackers. Under standardized event types, this must be recorded under:
(A) Execution, delivery and process management
(B) Employment practices and workplace safety
(C) Internal fraud
(D) External fraud

May/June 2007

62. Given below are two statements, one labeled as Assertion (A) and the other labeled as Reason (R). Select the correct answer from the options provided.
Assertion (A): Under the revised Basel III

framework released by the RBI in 2024, the requirements for a separate regulatory capital charge for operational risk do not apply to Regional Rural Banks.
Reason (R): Regional Rural Banks are excluded from the scope of the Master Direction on Operational Risk Management and Operational Resilience.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2015

63. Product teams or activity groups within a bank use a variety of products for the delivery of service. Which of the following is NOT typically considered a product under the 'general banking' or 'commercial banking' activity group?
(A) Term loans
(B) Overdrafts
(C) Hardware architecture design
(D) Letters of credit

May/June 2020

64. Read the following scenario and identify the operational risk event category:
Due to a major unannounced utility outage in the city's financial district, Omega Bank's primary data center lost power for six hours. The backup generators failed to activate due to lack of maintenance. Consequently, the bank could not process thousands of wire transfers, leading to severe financial penalties and customer claims. Under which operational risk event category does this loss fall?
(A) Damage to physical assets
(B) Clients, products, and business practices
(C) Business disruption and system failures
(D) Internal fraud

Oct/Nov 2025

65. Match the terms related to Cause and Effect analysis with their correct classifications:
List I: Terms
P. Restitution
Q. Obsolete applications
R. Write-downs
S. Inadequate segregation of duties
List II: Classifications
1. Consequence impacting assets directly
2. System/Technology Cause
3. Operational control based Cause
4. Consequence involving compensation or refund
(A) P-4, Q-2, R-1, S-3
(B) P-1, Q-3, R-4, S-2
(C) P-3, Q-1, R-2, S-4
(D) P-2, Q-4, R-3, S-1

May/June 2013

66. In the operational risk identification process, what is the primary advantage of combining both the top-down and bottom-up approaches?
(A) It ensures that only senior management is burdened with risk identification tasks.
(B) It eliminates the need for capturing operational risk loss data from external industry databases.
(C) It guarantees that capital allocation is calculated solely based on bottom-up risk event aggregation.
(D) It identifies large exposures at the macro level while capturing granular, process-level vulnerabilities.

Oct/Nov 2019

67. Read the following case study and identify the mandate of the staff member:
Sarah is appointed as the Operational Risk Liaison for the Retail Banking division of Nexus Bank. During her quarterly review, she notices that a critical regulatory compliance issue raised by the External Auditor has remained open and unresolved for 90 days. Based on her specific responsibilities as a liaison, what is her immediate mandate regarding this issue?
(A) To personally rewrite the bank's enterprise-wide risk management policy.
(B) To redesign the core banking information technology systems.
(C) To approve the operational risk capital methodology for the retail division.
(D) Being responsible for the timely follow-up and documentation of action plans for the open issue.

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May/June 2016

68. Read the following scenario and identify the peculiarity of operational risk it illustrates:
An investment bank recently expanded its portfolio by launching a proprietary trading desk. While the market and credit risks of this new venture were meticulously calculated and backed by expected higher returns, the bank's HR department rushed the hiring process, failing to conduct proper background checks. Six months later, a trader engaged in unauthorized massive trades resulting in a severe loss.
(A) Operational risk arises inevitably in the natural course of corporate activity as soon as an employee is hired, unlike market risk.
(B) It is easy to collateralize operational risk against trading margins to offset potential credit defaults.
(C) Operational risk is directly taken in return for an expected reward to maximize future capital gains.
(D) Operational risk only occurs when a firm decides to do business with a particular external counterparty.

Oct/Nov 2007

69. Match the four-pronged approach components utilized by ORMD to develop risk profiles with their corresponding implementation aspects:
List I: ORMD Approach Components
P. Risk Indicators
Q. Self-Assessment
R. Loss Database
S. Capital Model
List II: Implementation Aspects
1. Joint responsibility for developing measurement methodology for strategic planning and cost benefit analysis
2. Facilitating periodic reviews internally to identify risk vulnerabilities
3. Statistics and metrics, often financial, to provide insight into risk position
4. Collecting and recording historical data of risk events and amounts lost
(A) P-3, Q-2, R-4, S-1
(B) P-1, Q-4, R-2, S-3
(C) P-4, Q-3, R-1, S-2
(D) P-2, Q-1, R-3, S-4

May/June 2025

70. Read the following scenario and identify the financial classification of the loss:
Following a system glitch that double-charged over 5,000 credit card holders, Apex Bank had to refund the erroneously charged amounts along with an additional apology credit to each customer's account to prevent reputational damage. In the context of cause and effect analysis of operational risk, the financial compensation paid out by the bank is classified as:
(A) A write-down
(B) Restitution
(C) A process-oriented cause
(D) Loss of recourse

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catastrophic systemic failures affecting large volumes of transactions simultaneously.

17. (A) To act as statistical metrics, often reviewed periodically, to alert the bank to changes indicative of risk concerns.
Key Risk Indicators serve as essential early warning tools within a monitoring framework. By tracking specific quantitative data over time, such as error rates or staff turnover, banks can identify emerging trends that suggest an increase in risk exposure. These metrics allow management to take proactive measures to mitigate potential issues before they escalate into material losses.

18. (C) Statement I is true, and Statement II is false.
The Board of Directors holds the ultimate responsibility for overseeing the institution's risk profile and ensuring a sound management framework. However, the internal audit function must remain separate from day-to-day operational risk processes to maintain its independence. Its role is to provide objective assurance and evaluate the effectiveness of the policies implemented by management rather than participating in them.

19. (D) The business unit forms the first line, the ORM function the second line, and the audit function the third line.
This governance model allocates specific responsibilities to ensure comprehensive risk oversight. Business units, as the first line, own and manage risks directly. The operational risk management and compliance functions serve as the second line, providing policy frameworks and challenge. Finally, internal audit acts as the third line, offering independent assurance to the board regarding the effectiveness of controls.

20. (A) Best Practices - Identifying practices from within the bank or external sources to manage operational risk.
The operational risk department engages in several core activities to strengthen the framework. Identifying best practices involves researching successful internal methods or external industry standards to enhance risk management. Other functions include developing risk indicator tools, consolidating loss data for reporting, and collaborating with insurance experts to mitigate potential financial impacts through external risk transfer mechanisms.

21. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Operational risk is fundamentally linked to the existence of an organization, appearing the moment processes are established or staff are hired. It is considered an inevitable risk because it is not sought for profit, unlike market risk which depends on deliberate positioning. This omnipresence makes it a constant factor that must be managed across every level of an institution.

22. (B) Changes in prevailing interest rates leading to a decline in the net interest margin.
Operational risk events specifically include internal fraud, external damage to physical property, and technological disruptions. These incidents stem from failures in people, processes, or systems. In contrast, fluctuations in interest rates and their impact on net interest margins are categorized as market risk or interest rate risk in the banking book, rather than being part of the operational risk framework.

23. (C) (I), (II), (III), and (IV) only
Operational risk liaisons play a vital role in coordinating risk management within specific business units. Their duties include facilitating self-assessments, capturing data for risk indicators, and recording actual loss events. They also ensure that management addresses and documents progress on issues raised by auditors. However, performing independent audits for regulatory compliance is the exclusive responsibility of the internal audit department.

24. (D) Inadequate segregation of duties
Analyzing operational risk involves distinguishing between the root causes and the resulting consequences. Effects typically manifest as financial impacts, such as asset write-downs, restitution payments to customers, or the direct loss of recourse. In contrast, an inadequate segregation of duties is a procedural failure or control weakness that serves as a

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include trust and estates, and trading involves securities, corporate finance typically covers advisory services and underwriting. Private lending and deposit-taking activities are instead mapped to retail or commercial banking business lines, depending on the nature of the clientele.

9. (B) Operational risk events can arise from people, process, and systems failures, but exclude events from external causes.
Identifying risk events involves recognizing incidents that could lead to material financial losses. A comprehensive framework must account for failures in internal processes, people, and systems. Crucially, external events such as natural disasters, external fraud, or third-party failures are major components of operational risk and must be included in the identification and monitoring processes.

10. (A) (I) and (II) only
The Board-level committee oversees the strategic direction of risk management by approving capital methodologies and determining critical matters for Board review. Its role is supervisory rather than executive. Daily operational management and the implementation of specific mitigation strategies are typically delegated to a lower-level executive committee, ensuring a clear distinction between governance and execution.

11. (A) (II), (IV), (I), (III)
Mapping operational risk using a macro-level approach involves a logical progression from broad segments to specific incidents. The process starts by identifying primary business lines, followed by breaking them into activity groups. Subsequently, the specific products used within those groups are identified. Finally, the individual risk events associated with these products are mapped for assessment.

12. (C) Systems risk encompasses natural disasters such as hurricanes, earthquakes, and civil disruptions.
Operational risk categories are clearly defined to ensure precise identification and mitigation. People risk involves human resource management, while process risk focuses on internal workflows. Legal risk covers regulatory compliance. However, natural disasters and civil disruptions are classified under external event risks rather than systems risk, which primarily concerns failures in hardware, software, or technology infrastructure.

13. (A) The risk resulting from inadequate or failed system infrastructure, including obsolete applications and poor design.
Technological causes of operational risk focus on the robustness and suitability of the institution's digital environment. This includes vulnerabilities arising from outdated software applications, inadequate hardware performance, and fundamental flaws in system architecture. Managing this category involves ensuring that the technology used to process transactions and store data is reliable, secure, and capable of supporting business demands.

14. (A) (III), (IV), (I), (II)
A structured identification process begins with the broad classification of business lines. Once defined, the specific product teams operating within those lines are identified. This leads to the cataloging of all financial products used by these teams. The final step involves listing the potential operational risk events that could occur during the life cycle of these products.

15. (A) (I), (II), and (III) only
This category covers losses resulting from failures in transaction processing or process management. Examples include manual data entry errors, mismanagement of collateral, and legal or financial disputes with vendors. While technical hardware or software failures contribute to operational risk, they are specifically classified under business disruption and system failures rather than process management events.

16. (A) Greater use of highly automated technology
As financial institutions transition from manual workflows to digital platforms, the nature of operational risk shifts. While automation significantly reduces individual human errors, it creates a dependency on complex systems. Consequently, a single technological failure can lead to widespread disruptions, transforming localized manual processing risks into potentially

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65. (A) P-4, Q-2, R-1, S-3
Cause and effect analysis requires distinguishing between procedural failures and financial consequences. Obsolete applications and inadequate segregation of duties are root causes—one technological and the other related to operational control. Conversely, financial impacts such as asset write-downs and restitution payments to customers are the consequences or effects of a risk event. Proper classification is vital for effective risk reporting and management.

66. (D) It identifies large exposures at the macro level while capturing granular, process-level vulnerabilities.
Utilizing both top-down and bottom-up approaches ensures a holistic view of the institution's risk profile. The top-down method allows senior management to identify significant exposures across business lines. Simultaneously, the bottom-up method captures detailed information about individual risk events and process-level failures. Combining these perspectives ensures that both systemic threats and localized operational weaknesses are addressed within the risk management framework.

67. (D) Being responsible for the timely follow-up and documentation of action plans for the open issue.
Operational risk liaisons act as the bridge between the central risk function and specific business units. Their responsibilities include ensuring that any issues identified by internal or external auditors are addressed promptly. This involves following up with the relevant departments to implement action plans and maintaining thorough documentation of the resolution status. They do not typically rewrite bank-wide policies or redesign core systems.

68. (A) Operational risk arises inevitably in the natural course of corporate activity as soon as an employee is hired, unlike market risk.
While market risk is often a deliberate choice made to earn financial rewards, operational risk is a pure risk that is a byproduct of doing business. It appears as soon as an institution establishes processes or hires staff. In this scenario, while the trading desk's market risk was planned, the operational risk resulting from poor hiring practices was an inherent and inevitable vulnerability.

69. (A) P-3, Q-2, R-4, S-1
The four-pronged approach used by risk departments integrates different data sources to build a comprehensive risk profile. Risk indicators provide periodic statistical insights. Self-assessments facilitate internal reviews to identify vulnerabilities. A loss database tracks historical incidents and financial impacts. Finally, capital models involve a collaborative effort to develop methodologies for quantifying risk exposure for strategic planning and capital allocation purposes.

70. (B) Restitution
In the analysis of operational risk effects, financial compensation paid to customers to rectify an error is classified as restitution. This includes refunds of erroneous charges and payments made to mitigate reputational damage. Unlike asset write-downs, which reflect a decrease in property value, restitution involves moving funds to external parties to resolve grievances caused by process failures.

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cause, potentially leading to subsequent risk events and financial losses.

25. (B) Outsourcing, specifically the non-availability of services in emergency situations.
Financial institutions often rely on third-party vendors for critical operations to improve efficiency. However, this creates a dependency where the vendor's internal issues, such as labor strikes or operational failures, directly impact the bank's ability to serve customers. This scenario illustrates how outsourcing can lead to significant service disruptions and reputational damage when contingency plans for vendor non-availability are inadequate.

26. (D) Operational risk commences before transactions are executed, continues during delivery, and remains after completion.
The lifecycle of operational risk spans the entire duration of a business activity. It begins during the initial stages of product design and transaction negotiation. It persists through the execution and processing phases where system or human errors might occur. Finally, it remains after the transaction is completed, manifesting as potential legal disputes, documentation errors, or data management issues.

27. (B) (I) and (III) only
Modern regulatory standards emphasize operational resilience as the primary outcome, ensuring institutions can withstand and recover from disruptions. While Regional Rural Banks are excluded from the scope of these directions, the framework applies to all Commercial Banks, including Small Finance Banks and Payments Banks, and covers regulated entities beyond just Scheduled Commercial Banks. This approach ensures systemic stability across the entire financial sector.

28. (A) (I), (II), and (IV) only
The executive-level risk committee focuses on prioritizing mitigation strategies and ensuring sufficient resources are allocated to manage operational threats. It also plays a key role in reviewing the risk profiles of new products before they are launched. However, setting the overall risk appetite is a fundamental governance function reserved for the Board of Directors, ensuring high-level strategic alignment.

29. (C) The policy must outline the roles of the independent bank-wide ORM function and line of business management.
A robust operational risk management policy serves as a foundational document that must be clearly communicated across the organization. It is essential that the policy defines the specific responsibilities of the independent risk function versus the business line managers. This clarity prevents overlaps or gaps in oversight and ensures that accountability is maintained at every level of the institution.

30. (A) P-4, Q-3, R-2, S-1
Categorizing risk events allows for standardized reporting and analysis. Internal fraud includes intentional employee misdeeds like insider trading. External fraud involves third-party actions like hacking or robbery. Workplace safety covers diversity and compensation claims. Finally, client-related events include fiduciary breaches. Correct mapping ensures that banks can track the frequency and severity of specific threat types accurately across their operations.

31. (C) Strategic Investments
The Basel framework identifies eight standard business lines for calculating operational risk capital charges. These include Corporate Finance, Trading and Sales, Retail Banking, Commercial Banking, Payment and Settlement, Agency Services, Asset Management, and Retail Brokerage. Strategic investments do not constitute a separate business line; instead, the risks associated with such activities are mapped to one of the eight established categories.

32. (B) External fraud
Operational risk events are classified based on the source and nature of the incident. When a loss is caused by a third party outside the organization—such as a coordinated cyber-attack by hackers intended to embezzle funds or damage data—it is categorized as external fraud. This distinguishes it from internal failures, technological disruptions, or errors made during the delivery of products.

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33. (B) Risk Mapping - Translating qualitative assessments into quantitative metrics using scorecards.
Assessment tools like self-assessments utilize workshops, while key risk indicators provide statistical monitoring. Risk mapping is specifically the process of visually or structurally charting business units and processes by risk type to identify vulnerabilities. In contrast, using scorecards to translate qualitative feedback into quantitative metrics is a technique typically associated with refined self-assessment methodologies or specific risk measurement models.

34. (D) Operational Risk Management Committee (ORMC)
Before a new product is introduced, its risk profile must be thoroughly analyzed and its mitigation processes evaluated. This critical oversight function is performed by the executive-level risk committee. They review the proposal against business potential and operational readiness, providing a formal recommendation to the Board's risk committee. This ensures that new ventures do not introduce unmanageable vulnerabilities into the institution.

35. (A) To ensure that both types of risks are treated appropriately according to their unique characteristics and underlying causes.
Distinguishing between these two terms is necessary for effective risk management. Operations risk typically focuses on the specific failures within back-office transaction processing and clerical tasks. Operational risk is a much broader regulatory category encompassing people, systems, and external events. Clear separation allows the bank to apply specialized controls and monitoring techniques tailored to the different origins of these risks.

36. (A) Decide upon mitigants rationally by looking at the costs of putting in mitigants against the benefit of reducing operational losses.
Implementing risk mitigants is a strategic decision that requires balancing financial investment against potential loss reduction. Banks should not attempt to eliminate all risks at any cost, as this is often economically unfeasible. Instead, management must perform a cost-benefit analysis to determine which controls provide the most effective protection relative to their implementation and maintenance expenses.

37. (A) P-3, Q-4, R-1, S-2
Governance involves distinct roles across various levels of the bank. The Board of Directors sets the overall framework, while the Board's risk committee approves specific capital methodologies. The executive risk committee handles the execution and maintenance of the management process. At the operational level, liaisons coordinate the capture of loss data, ensuring a comprehensive flow of risk information upward.

38. (A) (I), (II), (III), and (IV) only
The Risk Management Committee of the Board acts as a high-level oversight body. Its responsibilities include approving operational risk policies, reviewing the bank's overall risk profile, and authorizing capital measurement methodologies. It also acts as a filter, deciding which critical matters require full Board approval. Operational tasks like facilitating unit-level self-assessments are typically handled by liaisons and business units rather than this committee.

39. (D) Employment practices and workplace safety
Operational risk events involving human resources are categorized under employment practices and workplace safety. This specific type includes losses arising from acts inconsistent with employment, health, or safety laws, such as discriminatory dismissal or workers' compensation claims. While legal action is involved, the root cause is related to the management of employees, placing it within this standardized Basel event category.

40. (D) The ORMC studies the risk profile of the new product and recommends it to the RMCB after reviewing mitigation processes.
The executive risk committee is responsible for ensuring that all new products undergo a rigorous "New Product Approval Process." This involves analyzing potential operational vulnerabilities and the effectiveness of proposed controls. By studying the risk profile and providing a formal recommendation to the

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Board's risk committee, the executive committee ensures that new business activities align with the institution's overall risk framework.

41. (B) ORMD analyzes data strictly on a comparative basis, ignoring individual basis analysis.
The operational risk department's data analysis function must be comprehensive to be effective. It involves evaluating risk data on an individual basis to understand specific failures, as well as on a consolidated and comparative basis to identify broader trends across the institution. Limiting analysis to only one method would prevent the bank from fully understanding and communicating its risk position to stakeholders.

42. (C) Clients, products, and business practices
This category includes losses resulting from a failure to meet professional obligations to specific clients or from the nature and design of products. Unauthorized trading on behalf of a client and the subsequent breach of fiduciary duty are classic examples of this risk. These incidents often lead to litigation and restitution payments, highlighting failures in professional conduct and business practices.

43. (B) Damage to physical assets
Operational risk events resulting from external natural forces, such as hurricanes, earthquakes, or floods, are classified as damage to physical assets. These events lead to the destruction of property, hardware, and essential documentation. Unlike system failures which involve technology malfunctions, this category specifically addresses the physical impact of external events on the bank's tangible infrastructure and the resulting financial costs.

44. (D) Statement I is false, and Statement II is true.
Developing a capital measurement methodology is a collaborative effort that requires input from various business areas to ensure the model reflects actual operational realities. The risk department does not work in isolation on this task. However, the department is directly responsible for selecting, purchasing, or developing and implementing the specialized tools used throughout the organization for its risk management programme.

45. (C) Third-party relationships
In contemporary banking, the traditional concept of outsourcing has evolved into the broader term of third-party relationships. This updated terminology reflects the complex web of external dependencies that banks maintain, including vendors, service providers, and strategic partners. Managing these relationships is a critical component of ensuring operational resilience and mitigating risks that originate from entities outside the bank's direct control.

46. (B) System/Technology - The risk resulting from inadequate or failed system infrastructure, obsolete applications, and poor design.
Establishing clear cause categories is essential for analyzing operational risk. System and technology causes specifically relate to failures in the institution's digital backbone, such as outdated software or poorly designed infrastructure. In contrast, people risk stems from human actions, while process-oriented causes involve failures in transaction workflows or internal controls, such as lack of supervision or inadequate segregation of duties.

47. (B) Assigning activities that belong to more than one business line to the most prominent or suitable business line.
When an institution's activities overlap multiple regulatory categories, mapping principles provide a structured approach for capital calculation. If a specific service, like private banking, involves elements of several lines, the entire activity is assigned to the most prominent or suitable business line. This ensures consistency in risk reporting and prevents the fragmentation of data across too many different categories.

48. (B) It must be allocated to the specific business line that it supports.
Under the standardized approach for mapping business lines, ancillary functions—such as IT support or human resources—are not treated as independent categories. Instead, they are allocated to the specific business line they primarily support. This method ensures that all costs and risks associated with a business activity, including its secondary support

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functions, are accurately captured within the appropriate capital charge calculation.

49. (A) Key Risk Indicators
Quantitative metrics like staff turnover rates and error frequencies are used as early warning signals to identify deteriorating control environments. These indicators provide a proactive way to monitor operational risk levels and alert management to potential vulnerabilities before they lead to financial losses. By tracking these metrics periodically, banks can take corrective actions to stabilize operations and enhance overall institutional resilience.

50. (D) (I), (II), (III), and (IV)
Several factors contribute to the rising profile of operational risk in modern banking. Highly automated technology can transform human errors into systemic failures, while e-commerce introduces new security threats. Organizational downsizing often weakens internal controls, and large-scale acquisitions can create integration challenges. These developments necessitate a more robust and comprehensive framework for identifying and managing diverse operational threats.

51. (D) Operational risk is not directly taken in return for an expected reward and is often difficult to collateralize.
Operational risk differs from market and credit risks because it is not a chosen path to profit but an unavoidable consequence of operating a business. While market risk involves taking positions for financial gain, operational risk arises from failures in internal processes or external events. Its intangible and systemic nature also makes it significantly harder to hedge or collateralize compared to financial risks.

52. (D) Legal and Compliance Risk
Legal and compliance risk specifically addresses the potential for financial loss and reputational damage resulting from violations of laws, regulations, or prescribed practices. This includes failure to comply with anti-money laundering requirements, tax codes, and labor laws. It is a subset of operational risk that focuses on the legal consequences of operational failures and the bank's adherence to the governing regulatory framework.

53. (C) A mandate to align the operational risk framework seamlessly with the bank's marketing and public relations campaign strategies.
An operational risk policy must focus on identifying loss event types, establishing analytical frameworks for quantification, and setting clear risk tolerance levels. It is a technical governance document designed to ensure institutional stability. Aligning this internal risk framework with marketing or public relations strategies is not a regulatory requirement and does not contribute to the technical management or mitigation of operational risks.

54. (C) Trading and Sales
Banking activities are categorized into specific business lines for regulatory capital mapping. A desk that focuses exclusively on executing trades and managing sales for securities and foreign exchange is accurately mapped to the trading and sales business line. This ensures that the operational risks inherent in high-volume, market-facing activities are identified and managed separately from retail or corporate banking functions.

55. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
To ensure a strong internal control environment, it is essential to separate the functions that manage risk from those that provide independent oversight. Internal audit must not be involved in day-to-day operational risk processes to avoid conflicts of interest. This structural independence allows the audit function to objectively evaluate the effectiveness of the bank's risk management policies and overall control framework.

56. (A) Working with the bank's insurance area to determine optimal insurance limits and coverage.
When a bank identifies potential high-severity losses, such as those from cyber-attacks, it may choose to transfer some of that risk to a third party. This involves collaborating with insurance specialists to determine the

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appropriate levels of coverage and policy limits. This strategy helps protect the bank's capital by providing financial restitution in the event of an extraordinary operational failure.

57. (A) Risk Mapping
Risk mapping is an assessment technique where various organizational functions or process flows are structured or charted by risk type. This visual approach helps identify geographical or structural areas of weakness within the institution. By revealing where risks are concentrated, mapping allows management to prioritize resources and interventions to address the most critical vulnerabilities in the bank's operational framework.

58. (A) The responsibility must always be assigned as a full-time position exclusively to a dedicated team of risk specialists.
Operational risk liaisons are responsible for coordinating risk management within their business areas, monitoring indicators, and following up on audit issues. However, these roles are not always full-time positions dedicated solely to risk. Often, these responsibilities are assigned to existing staff within the business unit who have a deep understanding of the local processes and can manage risk activities alongside their primary duties.

59. (A) P-2, Q-4, R-1, S-3
Understanding the root causes of operational risk is essential for effective mitigation. People-related causes involve employee actions, while transaction-based causes stem from business volume and product complexity. Operational control failures include inadequate segregation of duties and lack of supervision. External causes encompass uncontrollable events like natural disasters or third-party failures. Correct classification ensures that the bank addresses the actual source of any disruption.

60. (A) (I) and (II) only
Self-assessments are internally driven processes that use tools like workshops and checklists to evaluate an institution's strengths and vulnerabilities. Risk mapping complements this by charting business units by risk type to highlight critical weaknesses. While key risk indicators are essential, they are quantitative statistical metrics used for periodic monitoring rather than being limited to qualitative surveys about employee morale and motivation.

61. (C) Internal fraud
Losses resulting from intentional acts by an employee to defraud the institution or circumvent company policy are classified as internal fraud. This includes activities such as embezzling funds, misreporting financial positions, and insider trading. Since this incident was orchestrated by a staff member within the bank without the involvement of external third parties, it falls squarely within the internal fraud category of operational risk.

62. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The Reserve Bank of India's 2024 Master Direction on Operational Risk Management provides a comprehensive framework for most banking institutions. However, it explicitly excludes Regional Rural Banks from its scope. Therefore, these banks are not required to maintain a separate regulatory capital charge for operational risk under this specific framework, as they are not governed by the provisions of this direction.

63. (C) Hardware architecture design
In the context of operational risk identification, products refer to the specific services or instruments offered to customers, such as term loans, overdrafts, and letters of credit. These are used within business lines like commercial or retail banking. Hardware architecture design is an internal technical support function or a project-related activity rather than a financial product delivered to the bank's clients.

64. (C) Business disruption and system failures
This category covers losses resulting from disruptions to business operations or the failure of essential systems. A power outage that shuts down a data center, combined with the failure of backup generators, directly prevents the bank from performing core functions like processing wire transfers. Such incidents highlight vulnerabilities in technical infrastructure and maintenance processes rather than physical damage to assets or internal fraud.

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ANSWERS

1. (D) An enabling culture led by the Board and senior management through an energized organizational change programme.
Effective operational risk management requires a top-down commitment where leadership fosters a risk-aware culture across the institution. This involves embedding risk consciousness into daily operations and strategic decision-making. Without strong governance and an energized change programme, technical tools or external advice cannot ensure a robust and sustainable framework for institutional resilience.

2. (D) April 30, 2024
The Reserve Bank of India issued the comprehensive Master Direction on Operational Risk Management and Operational Resilience on this specific date. These guidelines were designed to align domestic regulatory standards with the international principles published by the Basel Committee on Banking Supervision in March 2021, emphasizing the need for robust institutional frameworks.

3. (C) Operational risk is omnipresent in business activities and typically not directly taken in return for an expected reward.
Operational risk is an inherent component of every business process, emerging naturally from people, systems, and external events. Unlike credit or market risks, which are deliberately assumed to generate financial returns, operational risk is a byproduct of doing business. It is difficult to collateralize and persists as long as an organization maintains its operations.

4. (A) Both Statement I and Statement II are true.
The top-down approach begins at the highest organizational level, analyzing business lines and large exposures to identify macro-level risks. Conversely, the bottom-up approach focuses on granular data collection from individual risk events occurring at the operational level. Combining these methods provides a comprehensive and multifaceted view of an institution's operational risk profile.

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5. (C) Assertion (A) is true, but Reason (R) is false.
Collaboration between the operational risk department and internal audit is essential for sharing information and reducing redundant activities. However, the internal audit function must maintain its independence to provide objective oversight. Allowing a risk management department to dictate the audit schedule would compromise this independence and undermine the effectiveness of the bank's control framework.

6. (A) (I), (II), (IV), and (V) only
An effective risk strategy focuses on mitigating financial losses and enhancing customer satisfaction by fixing process failures. It involves identifying product vulnerabilities that lead to fraud and evaluating technology-related threats. Furthermore, ensuring business continuity during external shocks is vital. Fostering conflict between employees is counterproductive and does not align with sound risk management principles.

7. (B) The risk of loss from failed processes, people, systems, or external events, including legal risk but excluding strategic risk.
Operational risk encompasses losses originating from internal failures or external incidents affecting the organization. This definition specifically includes legal risk, which covers fines and penalties, but excludes strategic and reputational risks. Understanding these boundaries is critical for accurate capital calculation and for establishing appropriate risk management boundaries within a complex financial institution environment.

8. (B) Private lending and deposits - Corporate Finance
Regulatory frameworks categorize banking activities into eight distinct business lines to calculate capital charges. While agency services

CHAPTER 18

Collection of Internal Loss Data and External Loss Data

May/June 2016

1. Losses can only be excluded after being included in the bank's operational risk loss database for a minimum period of:
(A) One year
(B) Two years
(C) Three years
(D) Five years

Oct/Nov 2009

2. Which statement regarding the exclusion of losses is incorrect?
(A) Banks may discontinue certain kinds of loss data collections if they are not pertinent, depending upon the change in lines of business.
(B) Exclusion of losses shall be subject to a materiality threshold and specific regulatory approval.
(C) Losses related to divested activities are subject to the same minimum 3-year operational risk loss database retention period before exclusion.
(D) Losses shall be excluded from the calculation of the ILM used for ORC calculation only after receiving the Reserve Bank's formal approval.

May/June 2023

3. Which of the following best defines a "near miss"?
(A) A specific loss event that falls exactly on the predefined minimum threshold used for automated data collection.
(B) An event that produces a temporary financial loss that is successfully recovered within the same designated accounting period.
(C) A sequence of events or an observation of unusual occurrences possessing the potential of improving a system's operability by reducing the risk of upsets.
(D) A significant financial loss resulting from outsourced activities that is ultimately fully paid by the third-party outsourcer.

Oct/Nov 2018

4. For legal loss events, which of the following is the most appropriate definition of the "date of accounting"?
(A) The date the lawsuit is formally filed in a court of law against the banking institution.
(B) The date the firm initially receives the formal legal notice regarding the alleged event.
(C) The date when a legal reserve is established for the probable estimated loss in the P&L.
(D) The date the final settlement is paid to the plaintiff after all appeals have been exhausted.

May/June 2007

5. Why must external data gathered from news sources be used with caution?
(A) News sources generally charge high annual subscription fees, which can significantly distort the total cost of the firm's risk management program.
(B) A large fraud receives intensive coverage, while a major systems outage might not make it into any press report, creating a reporting bias.
(C) News sources exclusively report on near-misses and potential threats rather than providing data on actual realized financial losses.
(D) News sources are strictly prohibited from reporting on specific banking losses due to regulatory confidentiality and national data laws.

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Oct/Nov 2025

6. What is the primary objective of using the "5-Whys" analysis technique?
(A) To conduct a complex statistical regression on large datasets to find the mathematical probability of a specific risk event occurring.
(B) To look at a problem and ask "why" and "what caused this problem" iteratively to get to the root of the problem quickly.
(C) To record and display all actions and conditions in a logical, tree-structured hierarchy to visualize the breakdown of internal controls.
(D) To evaluate the changes in system configurations systematically after a failure to ensure that new policies are being followed correctly.

May/June 2012

7. What is the precise interpretation of "operational risk event data"?
(A) It refers exclusively to direct financial losses actually suffered and recognized by the firm.
(B) It refers to both internal and external risk events, including events that have not resulted in direct losses.
(C) It refers only to economic losses that result specifically from external factors outside the firm's direct control.
(D) It refers strictly to specific losses recognized and accounted for in the bank's profit and loss (P&L) statements.

Oct/Nov 2014

8. Which statement correctly describes "Failure Mode and Effects Analysis" as a root-cause analysis method?
(A) It is an investigation method that involves the tracing of pathways by which a target is adversely affected by a hazard.
(B) It is a "system engineering" process that examines failures in products or processes.
(C) It is a statistical technique used for analysis of a limited number of tasks that produce a significant overall effect.
(D) It is an analysis tool that places the event at the root of a "tree of logic".

May/June 2019

9. All of the following are categorized under "Execution, Delivery, and Process Management" EXCEPT:
(A) Miscommunication
(B) Utility outage/disruptions
(C) Collateral management failure
(D) Unapproved access given to accounts

Oct/Nov 2006

10. How should a bank treat the financial impacts of operational loss events from outsourced activities that are fully paid by the outsourcer rather than by the bank?
(A) They must be included in the dataset as operational losses of the bank to reflect the overall risk exposure.
(B) They must be recorded specifically as near-misses in the internal operational risk database.
(C) They are not operational losses of the bank and therefore shall not be included in the dataset as operational losses.
(D) They must be included as gross losses and simultaneously recorded as insurance recoveries in the database.

May/June 2021

11. According to the structured investigation framework of Root-Cause Analysis, arrange the following steps in the correct sequential order:
I Problem caused by data analysis
II Problem cause data collection
III Root cause elimination
IV Problem cause brainstorming
(A) (II), (I), (IV), (III)
(B) (IV), (II), (I), (III)
(C) (I), (IV), (II), (III)
(D) (IV), (I), (II), (III)

Oct/Nov 2010

12. What is the minimum threshold prescribed for including a loss event in the data set?
(A) ₹ 10,000
(B) ₹ 50,000
(C) ₹ 1,00,000
(D) ₹ 5,00,000

May/June 2005

13. Which of the following statements regarding exclusions from gross loss computation is incorrect?

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(A) Legal expenses directly related to the event and fees paid to advisors are excluded.
(B) Costs of general maintenance contracts on property are excluded.
(C) Internal expenditures to enhance the business after an operational risk event are excluded.
(D) Insurance premiums are excluded.

Oct/Nov 2022

14. Which of the following correctly lists the categories categorized as Level 1 Basel risk categories?
(A) Internal Fraud; Market Manipulation and Insider Trading; Diversity and Discrimination; Damage to Physical Assets and Premises.
(B) Theft and Fraud; Systems Security and Information Hacking; Model Errors; Execution, Delivery, and Process Management.
(C) Internal Fraud; External Fraud; Employment Practices and Workplace Safety; Clients, Products, and Business Practices.
(D) Unauthorized Activity; Safe Environment and Workplace Conditions; Vendor Disputes; Business Disruption and System Failures.

May/June 2018

15. What is the most accurate treatment of receivables concerning the definition of recoveries?
(A) Receivables count as immediate recoveries and reduce the gross loss amount upon the identification of the event.
(B) Receivables are treated strictly as near-misses and are categorized under the umbrella of opportunity costs.
(C) Receivables are added to the gross loss amount to reflect the potential future exposure the bank may face.
(D) Receivables do not count as recoveries; recoveries can only reduce losses after the bank receives payment.

Oct/Nov 2016

16. How is "Net Loss" defined in the context of operational risk data?
(A) The loss after taking into account the impact of recoveries, where recovery is an independent occurrence related to the original loss event.
(B) The total gross loss amount calculated before accounting for any subsequent insurance claims or legal settlements.
(C) The total loss amount minus any pending receivables or expected payments that the bank currently anticipates to collect.
(D) The total financial impact of a risk event minus the recurring general maintenance costs typically incurred during business.

May/June 2014

17. The Root-cause analysis (RCA) approaches applied sequentially at different points in the analysis include all of the following EXCEPT:
(A) Capital adequacy recalculation
(B) Problem understanding
(C) Problem cause brainstorming
(D) Solution implementation

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Oct/Nov 2007

18. The Pareto Analysis method in root-cause analysis is based on the premise that what percentage of problems are produced by a few critical causes?
(A) 60%
(B) 70%
(C) 80%
(D) 90%

May/June 2025

19. Identify the incorrect statement concerning near-misses and opportunity costs.
(A) Near-misses are viewed as positive experiences encouraging employees to report rather than hide.
(B) The event itself is still a concern to the firm as it indicates that control has failed or a process is flawed.
(C) Loss databases are often renamed to "operational risk event database" to reflect the inclusion of gains, near-misses, and opportunity costs.
(D) Opportunity costs, such as lost revenue from a failed trading system, are excluded from the loss database as they do not represent direct losses.

(D) (II), (III), and (IV)

May/June 2012

56. Match the items in List I to their treatment in the loss data set in List II.

List I: (Items)

P. Direct charges to P&L accounts
Q. Costs of general maintenance contracts
R. Insurance premiums
S. Material pending losses in suspense accounts

List II: (Treatment)

1. Included in gross loss computation
2. Excluded from gross loss computation
3. Included in gross loss computation
4. Excluded from gross loss computation

(A) P-1, Q-2, R-4, S-3
(B) P-1, Q-3, R-2, S-4
(C) P-2, Q-1, R-4, S-3
(D) P-3, Q-4, R-1, S-2

Oct/Nov 2009

57. A mid-level trader at a bank intentionally mismarks their trading position to hide losses, resulting in a severe monetary deficit when discovered. According to the Basel categories, under which Level 1 and Level 2 categories should this event be recorded?

(A) Level 1: Internal Fraud; Level 2: Unauthorized Activity
(B) Level 1: External Fraud; Level 2: Systems Security
(C) Level 1: Clients, Products, and Business Practices; Level 2: Improper Business or Market Practices
(D) Level 1: Execution, Delivery, and Process Management; Level 2: Trade Counterparties

May/June 2016

58. Consider the following statements regarding the categorization of loss data:

I The Basel risk categories are used to capture a risk event, not a cause.
II "Losses due to acts of a type intended to defraud by a third party" falls under Internal Fraud.

Which of the above statement(s) is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2019

59. Consider the following steps involved in Root-cause analysis (RCA):

I Problem understanding
II Problem cause brainstorming
III Problem caused by data analysis
IV Root cause identification
V Regulatory capital deduction

Which of the above represents valid phases in the RCA approach?

(A) (I), (II), (III), and (V)
(B) (I), (II), (IV), and (V)
(C) (I), (II), (III), and (IV)
(D) (II), (III), (IV), and (V)

May/June 2025

60. Consider the following items regarding gross loss computation:

I Write-downs due to the operational risk event.
II Legal expenses directly related to the event.
III Upgrades and risk assessment initiatives implemented after the event.

Which of the above statement(s) must be INCLUDED in the gross loss computation?

(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2007

61. Following a major compliance failure, the risk management team conducts a session where they repeatedly ask "what caused this problem" starting from the main issue, drilling down layer by layer to uncover the fundamental process gap. Which simple problem-solving technique are they using?

(A) Ishikawa Diagram
(B) Fault Tree Analysis
(C) 5-Whys Analysis
(D) Failure Mode and Effects Analysis

May/June 2009

62. Due to a massive network utility outage, Bank B's trading platform goes offline for a full day. While no direct financial penalties or write-downs were incurred, the bank calculates that it missed out on ₹10,00,000 in expected

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against operational risks by providing insight into risks faced and offering sample inputs for scenario analysis.
(B) It eliminates the operational requirement for maintaining an extensive internal loss database by using external industry benchmarks instead.
(C) It provides a guaranteed and immediate reduction in the internal capital requirement calculated under the standard Basel regulatory framework.
(D) It replaces the need for independent periodic reviews by internal and external auditors regarding the bank's operational risk controls.

Oct/Nov 2015

28. How are operational loss events related to credit risk treated for data collection purposes?
(A) Operational loss events related to credit risk that are accounted for in credit RWA shall not be included, but those not accounted for in credit RWA shall be included.
(B) All operational loss events related to the credit risk must be included in the database, regardless of how they are accounted for under the framework.
(C) All operational loss events related to credit risk must be excluded from the operational loss data set to prevent the potential for double counting.
(D) Operational loss events related to credit risk must be included only if they happen to exceed the bank's specifically calculated average credit loss.

May/June 2013

29. All of the following Activity Examples (Level 3) belong to the "Internal Fraud" category EXCEPT:
(A) Transactions not reported (intentional)
(B) Check kiting
(C) Insider trading (on firm's account)
(D) Insider trading (not on firm's account)

Oct/Nov 2021

30. Regarding the collection of reference dates for operational risk events, which statement is correct?
(A) A bank is only required to collect the "date of accounting" for reporting purposes.
(B) A bank shall use a date later than the date of accounting for including losses related to legal events.
(C) The "date of occurrence" represents the date when a loss is officially recognized in the P&L accounts.
(D) A bank shall collect the "date of occurrence", the "date of discovery", and the "date of accounting".

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May/June 2024

31. Which of the following Root-Cause Analysis methods is correctly paired with its defining characteristic?
(A) Pareto Analysis — Examines failures in products or processes using system engineering.
(B) 5-Whys Analysis — Uses 80/20 statistical premise for decision making.
(C) Fault Tree Analysis — The event is placed at the root (top event) of a "tree of logic".
(D) Failure Mode and Effects Analysis — Focuses on tracing hazard pathways and missing countermeasures.

Oct/Nov 2008

32. Consider the following statements regarding the categorization of activity examples:
I Hacking damage falls under External Fraud.
II Bribes/kickbacks (willful) falls under Internal Fraud.
III Client permissions missing falls under Execution, Delivery, and Process Management.
IV Model errors falls under Clients, Products, and Business Practices.
V Hardware outage falls under Damage to Physical Assets.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (IV)
(B) (I), (II), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

May/June 2006

33. Match the Activity Examples Level 3 in List I with their appropriate Level 1 Category in List II.
List I: (Activity Examples Level 3)
P. Hacking damage

Oct/Nov 2019

20. Which of the following items shall be included in the gross loss computation of the loss data set?

(A) Provisions or reserves accounted for in the P&L against the potential operational loss impact.

(B) Costs of general maintenance contracts on property, plant, or equipment.

(C) Expenditures to enhance the business after the operational risk, such as upgrades.

(D) Insurance premiums.

May/June 2009

21. Arrange the following reference dates for an operational risk event in the logical chronological sequence they typically occur:

I Date of accounting

II Date of occurrence

III Date of discovery

(A) (II), (III), (I)

(B) (I), (II), (III)

(C) (III), (II), (I)

(D) (II), (I), (III)

Oct/Nov 2011

22. Exclusion of losses shall be subject to a materiality threshold. The excluded loss event shall be greater than what percentage of the bank's average losses?

(A) 2%

(B) 5%

(C) 10%

(D) 15%

May/June 2010

23. Which of the following accurately describes "timing losses" in the context of gross loss computation?

(A) Financial losses resulting from a significant delay in executing customer orders within the prescribed market hours and regulatory windows.

(B) Temporary financial losses that are fully reversed within the same trading day due to automated system corrections or manual overrides.

(C) Specific losses caused by the premature termination of a long-term vendor contract or the cancellation of a professional service agreement.

(D) Negative economic impacts booked in a financial accounting period due to operational risk events impacting the cash flows or financial statements of previous accounting periods.

Oct/Nov 2024

24. While establishing a loss data set, a bank is required to document all of the following reference dates EXCEPT:

(A) The date when the event happened (date of occurrence).

(B) The date on which the bank became aware of the event (date of discovery).

(C) The date when a loss event results in a loss being recognized in the P&L accounts (date of accounting).

(D) The date the regulatory authority officially closed the investigation of the event.

May/June 2017

25. Which of the following mappings of Level 2 categories to Activity Examples (Level 3) is incorrect?

(A) Unauthorized Activity - Intentional mismarking of trading positions

(B) Improper Business or Market Practices - Retail customer disclosure violations

(C) Safe Environment - Specific events involving employee health and safety rules

(D) Product Flaws - Significant model errors and design failures

Oct/Nov 2005

26. What is the definition of "Root cause analysis"?

(A) An automated procedure used to calculate the economic capital required for operational risk under Basel.

(B) A statistical technique used exclusively for predicting future market movements and volatility.

(C) An investigation limited to assessing the financial impact of external frauds on a firm's balance sheet.

(D) A structured investigation that aims to identify the true cause of a problem and the actions necessary to eliminate it.

May/June 2020

27. What is the primary benefit of collecting external loss data, in addition to internal data?

(A) It perceives threat and builds resilience

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Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

May/June 2011

39. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct option.
Assertion (A): Receivables expected from insurance claims do not count as recoveries in the loss dataset.
Reason (R): Recoveries can be used to reduce losses only after the bank physically receives payment.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2020

40. Which of the following is incorrectly paired according to specific criteria on loss data identification?
(A) Gross loss — Loss before recoveries of any type.
(B) Net loss — Loss after taking into account the impact of recoveries.
(C) Recovery — An independent occurrence related to the original loss event in which economic benefits are received.
(D) Receivables — Counted as recoveries immediately upon identification.

May/June 2022

41. According to the bank's internal policy, how should a bank convert an operational loss impact that occurred in GBP into INR?
(A) Using the official market exchange rate prevailing on the precise "date of occurrence" of the event.
(B) Using the same exchange rate that is used to convert them in the bank's financial statements of the period in which the loss impacts are accounted for.
(C) Using the official market exchange rate prevailing on the "date of discovery" when the bank first noticed the event.
(D) Using a standard historic exchange rate specifically mandated by the central bank for that designated financial year.

Oct/Nov 2023

42. Match the Root-Cause Analysis Methods in List I with their definitions in List II.
List I: (Root-Cause Analysis Methods)
P. Barrier Analysis
Q. Change Analysis
R. Causal Factor Tree Analysis
S. Fish-Bone Diagram
List II: (Definitions)
1. Used to record and display in a logical tree-structured hierarchy all actions necessary for a consequence.
2. Tracing of pathways by which a target is adversely affected by a hazard.
3. Looks systematically for possible risk impacts where system configurations or policies are revised.
4. Provides a systematic way of looking at effects and causes, also known as Ishikawa diagram.
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-2, R-4, S-1
(D) P-4, Q-1, R-3, S-2

Oct/Nov 2025

43. Consider the following regarding recognized Root-Cause Analysis (RCA) methods:
I 5-Whys Analysis
II Causal Factor Tree Analysis
III Ishikawa Diagram
IV Monte Carlo Simulation
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (I), (III), and (IV)
(D) (II), (III), and (IV)

May/June 2014

44. Consider the following statements regarding loss categories:
I "Theft/Robbery Forgery" is an activity example under External Fraud.

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Q. Tax noncompliance/evasion
R. Fiduciary breaches
S. Missed deadline or responsibility

List II: (Level 1 Category)
1. Internal Fraud
2. External Fraud
3. Clients, Products, and Business Practices
4. Execution, Delivery, and Process Management

(A) P-1, Q-2, R-3, S-4
(B) P-2, Q-1, R-3, S-4
(C) P-3, Q-4, R-1, S-2
(D) P-4, Q-3, R-2, S-1

Oct/Nov 2017

34. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct option.

Assertion (A): Extracting operational loss data purely from news articles presents significant challenges.

Reason (R): News coverage often exhibits bias, such as extensively reporting major frauds while ignoring major system outages.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2008

35. Consider the following statements regarding the exclusion of losses:

I Regulatory authorities expect the bank to demonstrate that excluded loss experience has no relevance to other continuing activities.
II Total loss amount and number of exclusions do not need to be disclosed as they are excluded from calculations.

Which of the above statement(s) is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2013

36. During an audit, it is found that a bank's relationship manager aggressively sold complex derivative products to retail clients without fulfilling the required KYC and retail customer disclosure requirements, leading to massive fines. How is this mapped?

(A) Clients, Products, and Business Practices (Suitability, Disclosure, and Fiduciary)
(B) Internal Fraud (Theft and Fraud occurring within the bank's internal systems)
(C) Execution, Delivery, and Process Management (Customer Intake and Documentation errors)
(D) Employment Practices and Workplace Safety (Internal employee relations and conduct)

May/June 2015

37. Match the Level 1 Basel Risk Categories in List I with their corresponding Level 2 Categories in List II.

List I: (Level 1 Basel Risk Categories)
P. Internal Fraud
Q. Employment Practices and Workplace Safety
R. Clients, Products, and Business Practices
S. Execution, Delivery, and Process Management

List II: (Level 2 Categories)
1. Suitability, Disclosure, and Fiduciary
2. Unauthorized Activity
3. Trade Counterparties
4. Diversity and Discrimination

(A) P-2, Q-4, R-1, S-3
(B) P-1, Q-2, R-4, S-3
(C) P-2, Q-1, R-3, S-4
(D) P-4, Q-3, R-1, S-2

Oct/Nov 2012

38. Consider the following rules concerning minimum loss data standards:

I A minimum loss of ₹10,000 is considered worthwhile to capture.
II The minimum threshold for including a loss event in the dataset is ₹1,00,000.
III Operational loss events related to credit risk accounted for in credit RWA must be included.
IV Banks shall document procedures and processes for internal loss data identification.

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for scenario analysis.
II Senior management is rarely interested in external events as they do not impact the firm's balance sheet directly.
III ORX and FIRST are examples of operational risk data providers.

Which of the above statement(s) is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2016

51. A bank uses a third-party vendor for transaction processing. The vendor makes a critical error causing a financial impact of ₹5,00,000. Under the contract, the vendor takes full responsibility and reimburses the bank the entire ₹5,00,000. How should the bank treat this in its operational loss dataset?
(A) Include ₹5,00,000 as a gross operational loss and ₹5,00,000 as a subsequent insurance recovery.
(B) Include ₹5,00,000 as a gross operational loss with no recovery since it involved an outsourced activity.
(C) Record the entire event under the category of External Fraud and classify it as a near-miss.
(D) The financial impact is not an operational loss of the bank and therefore shall not be included in the dataset.

May/June 2023

52. Which of the following Level 3 Activity Examples is correctly paired with its Level 1 Loss Event Category?
(A) Malicious destruction of assets — Categorized as External Fraud event.
(B) Check kiting — Categorized as Execution, Delivery, and Process Management.
(C) Aggressive sales — Categorized as Internal Fraud involving bank employees.
(D) Market manipulation — Clients, Products, and Business Practices.

Oct/Nov 2014

53. Consider the following statements regarding minimum loss data standards:
I Loss impacts denominated in a foreign currency shall be converted using the exchange rate prevailing on the date of occurrence.
II Operational risk losses related to market risk shall be included in the operational loss data set.

Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2019

54. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct option.
Assertion (A): Operational loss events related to credit risk that are accounted for in credit RWA must be included in the operational loss data set.
Reason (R): Basel standards mandate the comprehensive capture of all material activities across all subsystems.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2006

55. Consider the following statements regarding the process of the exclusion of losses:
I It requires approval from the relevant regulatory authority.
II The excluded loss event must be greater than 5% of the bank's average losses.
III Losses must be in the operational risk loss database for a minimum of five years before exclusion.
IV Exclusions are disclosed under Pillar 3 with appropriate narratives.

Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (I), (II), and (IV)

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II "Smuggling" is an activity example under Internal Fraud.
III "Workers' compensation" is an activity example under Employment Practices and Workplace Safety.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2018

45. A bank's IT system experiences a severe cyber-attack from an unidentified third-party hacker group, resulting in significant hacking damage and theft of information with monetary loss. In which Basel category should this event be mapped?
(A) Execution, Delivery, and Process Management
(B) Business Disruption and System Failures
(C) External Fraud
(D) Damage to Physical Assets

May/June 2021

46. Match the Level 2 Categories in List I with their corresponding Activity Examples Level 3 in List II.
List I: (Level 2 Categories)
P. Disasters and Other Events
Q. Employee Relations
R. Product Flaws
S. Vendors and Suppliers
List II: (Activity Examples Level 3)
1. Compensation, benefit, termination issues
2. Outsourcing disputes
3. Human losses from external sources (terrorism)
4. Model errors
(A) P-3, Q-1, R-4, S-2
(B) P-1, Q-4, R-2, S-3
(C) P-2, Q-3, R-1, S-4
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2010

47. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct option.
Assertion (A): Near-misses are considered valuable opportunities to manage operational risk proactively.
Reason (R): An event might produce no loss at all but can indicate an unmitigated operational risk or a flawed control process.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2005

48. Which of the following Activity Examples is incorrectly paired with its Level 2 Category?
(A) Mismarking of position (intentional) — Unauthorized Activity
(B) Hardware outage — Disasters and Other Events
(C) Account churning — Suitability, Disclosure, and Fiduciary
(D) Exceeding client exposure limits — Selection, Sponsorship, and Exposure

NODIA

Oct/Nov 2022

49. Consider the following statements concerning inclusion and exclusion from gross loss computation:
I Timing losses spanning more than one financial period are included.
II Material pending losses in suspense accounts are included.
III Costs incurred to restore the position prevailing before the event are included.
IV Costs of general maintenance contracts on property are included.
V External expenditures to enhance the business after the operational risk are excluded.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (IV)
(B) (I), (II), (III), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

May/June 2018

50. Consider the following statements regarding external loss data:
I External events can provide sample input

trading revenue. How should this event be characterized?
(A) Opportunity Cost / Lost Revenue
(B) Gross Loss
(C) Timing Loss
(D) Pending Loss

Oct/Nov 2011

63. An operational risk event causes a write-down of ₹2,00,000. The bank incurs ₹50,000 in external legal expenses directly related to the event, pays ₹20,000 in general maintenance contracts, and pays an insurance premium of ₹30,000. What is the correct Gross Loss amount to be recorded in the data set?
(A) ₹ 2,00,000
(B) ₹ 2,50,000
(C) ₹ 2,70,000
(D) ₹ 3,00,000

May/June 2010

64. An investigator records all the necessary and sufficient conditions that led to a severe unauthorized trading incident. The investigator displays these actions and conditions in a logical, tree-structured hierarchy to demonstrate how the consequence occurred. Which technique is this?
(A) Fish-Bone Diagram
(B) Change Analysis
(C) Causal Factor Tree Analysis
(D) Pareto Analysis

Oct/Nov 2024

65. Due to a systematic accounting error spanning three financial years, a bank discovers it must book a negative economic impact in the current financial accounting period to rectify cash flows of the previous periods. Under what concept should this be included in the operational risk data set?
(A) Opportunity costs
(B) Material "timing losses"
(C) Immaterial pending losses
(D) Internal enhancements

May/June 2017

66. Bank A's average operational losses over the period amount to ₹10 Crores. The bank wishes to exclude a specific loss event related to a divested business from its database calculations. The loss event in question amounts to ₹40 Lakhs. Can Bank A request the exclusion of this loss based on the materiality threshold, and what is the applicable retention rule?
(A) Yes, because ₹40 Lakhs is 4% of ₹10 Crores, and losses from divested activities are exempt from the standard minimum retention period.
(B) Yes, because any loss related to divested activities can be excluded immediately regardless of the historical amount or time elapsed.
(C) No, because all losses related to divested activities must be retained in the bank's internal database for a minimum period of 3 years.
(D) No, because the excluded loss event must be greater than 5% of the bank's average losses (i.e., $>$ ₹50 Lakhs).

Oct/Nov 2005

67. A bank analyzes 500 minor operational errors logged over a year. The risk team uses a statistical technique and discovers that 400 of these errors (80%) stem from just two specific software glitches (which represent less than 20% of their systems). What technique did the bank employ?
(A) Barrier Analysis
(B) Change Analysis
(C) Causal Factor Tree Analysis
(D) Pareto Analysis

May/June 2020

68. An engineering team at the bank is investigating why a data center overheated. They map out the events focusing on identifying the pathways by which the cooling system was adversely affected by the power surge, specifically looking for failed or missing countermeasures. Which RCA method is being utilized?
(A) Barrier Analysis
(B) Pareto Analysis
(C) Change Analysis
(D) 5-Whys Analysis

Oct/Nov 2015

69. An ongoing internal investigation identifies operational risk events with definitive financial impacts that are temporarily booked in suspense accounts, pending final resolution. How should these "pending losses" be treated for the loss data set?

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8. (B) It is a "system engineering" process that examines failures in products or processes.
Failure Mode and Effects Analysis is a systematic, proactive method used to evaluate processes and identify where and how they might fail. Developed within system engineering, it assesses the relative impact of different failures to prioritize risk mitigation efforts. This approach helps organizations understand potential vulnerabilities in products or operational workflows, ensuring that critical controls are robust enough.

9. (B) Utility outage/disruptions
Execution, Delivery, and Process Management focuses on failures in transaction processing or process management. While miscommunication, collateral management failures, and unauthorized account access fall under this category, utility outages are classified elsewhere. Specifically, disruptions caused by utility failures are mapped to the Business Disruption and System Failures category, as they represent external infrastructure-related risks rather than process errors.

10. (C) They are not operational losses of the bank and therefore shall not be included in the dataset as operational losses.
When a third-party service provider bears the entire financial burden of an operational error, the bank does not experience a direct financial loss. According to regulatory standards, these impacts should not be included in the bank's primary operational risk loss dataset. While the event indicates a potential risk in outsourced processes, the lack of financial impact excludes it.

11. (B) (IV), (II), (I), (III)
A structured root-cause analysis begins with brainstorming potential causes to explore various possibilities. This is followed by collecting relevant data to validate these theories. Once the data is gathered, it is analyzed to pinpoint the actual cause of the failure. Finally, the process concludes with the elimination of the identified root cause to prevent future occurrences of the problem.

12. (C) ₹ 1,00,000
Regulatory guidelines establish a specific materiality threshold to ensure that operational risk databases focus on significant events. Currently, the minimum threshold for including a loss event in the standardized dataset is one lakh rupees. This requirement helps banks manage data collection efficiently by filtering out minor, high-frequency events that do not materially impact the overall operational risk profile or calculations.

13. (A) Legal expenses directly related to the event and fees paid to advisors are excluded.
In the calculation of gross operational losses, certain costs are mandatory inclusions while others are excluded. External legal expenses and advisor fees that are directly attributable to an operational risk event must be included in the gross loss figure. These expenses represent a direct financial impact resulting from the event, unlike general maintenance costs or insurance premiums, which are excluded.

NODIA

14. (C) Internal Fraud; External Fraud; Employment Practices and Workplace Safety; Clients, Products, and Business Practices.
The Basel framework classifies operational risk into seven distinct Level 1 categories to standardize reporting across the banking industry. These primary categories include internal and external fraud, employment practices, and client-related business practices. Accurate mapping to these categories is essential for consistent risk assessment and regulatory compliance, allowing for a uniform understanding of the types of operational threats.

15. (D) Receivables do not count as recoveries; recoveries can only reduce losses after the bank receives payment.
Within operational risk accounting, recoveries are defined as economic benefits actually received to offset a loss. Receivables represent expected future payments but do not constitute realized funds. Therefore, receivables cannot be used to reduce the reported gross loss amount until the bank has physically received the payment. This conservative approach ensures

ANSWERS

1. (C) Three years
To ensure data integrity and historical accuracy, banks must maintain operational risk loss records for a specific duration. This three-year retention period allows for adequate oversight and verification before any loss data is removed from the active database. Regulatory guidelines mandate this timeframe to prevent premature exclusion of events that might still possess relevance for risk calculations.

2. (C) Losses related to divested activities are subject to the same minimum 3-year operational risk loss database retention period before exclusion.
While most operational risk losses require a three-year retention period before exclusion, losses specifically related to divested activities are treated differently. Once a business unit is sold or discontinued, the associated historical losses may no longer reflect the current risk profile. Consequently, these specific losses do not strictly adhere to the standard three-year database retention requirement before exclusion.

3. (C) A sequence of events or an observation of unusual occurrences possessing the potential of improving a system's operability by reducing the risk of upsets.
A near miss represents an event that could have resulted in a significant loss but was averted due to luck or timely intervention. Analyzing these occurrences provides valuable insights into potential control weaknesses without the burden of an actual financial impact. They serve as early warning signals, helping institutions strengthen their operational resilience by identifying and mitigating risks.

4. (C) The date when a legal reserve is established for the probable estimated loss in the P&L.
The date of accounting for legal loss events marks the moment when a financial obligation is formally recognized within the institution's books. This occurs when a legal reserve is established to cover the estimated probable loss. Proper documentation of this date ensures that the loss is correctly aligned with the financial reporting period, facilitating accurate tracking of impacts.

5. (B) A large fraud receives intensive coverage, while a major systems outage might not make it into any press report, creating a reporting bias.
Media coverage of operational risk events often prioritizes high-profile incidents like large-scale frauds while ignoring less sensational but equally critical failures such as internal system outages. This discrepancy creates a significant reporting bias in datasets derived solely from news sources. Consequently, risk managers must exercise caution when using such data to ensure it accurately reflects the landscape.

6. (B) To look at a problem and ask "why" and "what caused this problem" iteratively to get to the root of the problem quickly.
The 5-Whys technique is a simple yet powerful tool used to identify the underlying cause of an operational failure. By repeatedly asking why an event occurred, investigators can move past superficial symptoms to uncover the fundamental process or control gap. This iterative approach facilitates rapid root-cause identification, allowing organizations to implement effective corrective measures and prevent recurrences.

7. (B) It refers to both internal and external risk events, including events that have not resulted in direct losses.
Operational risk event data encompasses a broad spectrum of information, covering both realized financial losses and incidents that did not lead to direct monetary impacts. This includes internal events within the bank and external events from the wider industry. By capturing near misses and potential threats alongside actual losses, institutions gain a comprehensive understanding of their risk exposure.

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can be used to reduce the recorded loss amount in the database.

41. (B) Using the same exchange rate that is used to convert them in the bank's financial statements of the period in which the loss impacts are accounted for.
For consistency between risk data and financial reporting, foreign currency operational losses must be converted using the exchange rates applied in the bank's official financial statements. This typically corresponds to the rate used during the period when the loss impact was formally accounted for. This alignment ensures that the operational risk database remains synchronized with the bank's reported earnings.

42. (A) P-2, Q-3, R-1, S-4
Barrier analysis focuses on pathways and failed countermeasures. Change analysis systematically evaluates the impact of revised policies or configurations. Causal factor tree analysis uses a logical hierarchy to map actions leading to a consequence. The Fish-Bone diagram provides a systematic visual method for analyzing causes and effects. These varied methods allow for comprehensive investigations into different types of operational failures.

43. (A) (I), (II), and (III)
Standard root-cause analysis techniques include the 5-Whys analysis for simple drilling, causal factor trees for logical mapping, and the Ishikawa diagram for visual categorization of causes. While Monte Carlo simulation is a powerful tool used in risk modeling and capital calculation to predict potential outcomes, it is a statistical simulation method rather than a qualitative root-cause investigation technique.

44. (D) (I), (II), and (III)
Basel categorization accurately places theft and forgery by third parties under external fraud. Smuggling or other illegal acts by employees fall under internal fraud. Furthermore, issues related to workers' compensation and employee health and safety are correctly mapped to the Employment Practices and Workplace Safety category. These examples help institutions categorize diverse operational incidents into standardized buckets for reporting.

45. (C) External Fraud
Cyber-attacks carried out by external parties with the intent to steal information or cause financial harm are classified as external fraud. Although the attack involves system failures or technological vulnerabilities, the defining characteristic is the malicious intent of a third party to defraud the institution. Therefore, hacking incidents are mapped to the External Fraud category rather than purely technological categories.

46. (A) P-3, Q-1, R-4, S-2
Disasters and other external events include human losses from acts like terrorism. Employee relations involve compensation, benefits, and termination disputes. Product flaws are typified by significant model errors that affect business outcomes. Finally, vendor and supplier risks include disputes arising from outsourced activities. These mappings help in the granular analysis of operational risk events by linking incidents to categories.

NODIA

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Near-misses are vital for proactive risk management because they reveal hidden weaknesses in controls. Even if no financial loss occurs, the fact that a process failed indicates a vulnerability that could lead to future damage. By investigating these events, banks can implement corrective actions before a similar incident results in a realized loss, thereby enhancing their overall operational resilience.

48. (B) Hardware outage — Disasters and Other Events
Hardware outages and other system-related failures are properly classified under the Business Disruption and System Failures category. The Disasters and Other Events sub-category under Damage to Physical Assets is intended for physical destruction caused by natural disasters or external human acts like vandalism. Distinguishing between technological outages and physical asset damage is crucial for accurate risk mapping and reporting.

that the loss data reflects actual financial impacts.

16. (A) The loss after taking into account the impact of recoveries, where recovery is an independent occurrence related to the original loss event.
Net loss represents the final financial impact of an operational risk event after all applicable recoveries have been applied. These recoveries must be independent events, such as insurance payouts or legal settlements, that directly offset the original gross loss. Calculating the net loss provides a realistic view of the actual economic damage sustained by the institution after mitigation.

17. (A) Capital adequacy recalculation
Root-cause analysis focuses on understanding, identifying, and solving the underlying reasons for operational failures. The process involves steps like problem understanding, brainstorming potential causes, and implementing solutions to prevent recurrence. While findings may inform risk assessments, the specific technical process of recalculating capital adequacy is a separate regulatory reporting function and not an inherent step within the investigative analysis framework.

18. (C) 80%
Pareto Analysis is founded on the principle that a small number of causes typically lead to a large majority of effects. In the context of operational risk, this suggests that approximately eighty percent of problems or losses are generated by roughly twenty percent of the underlying causes. This statistical observation helps risk managers prioritize their efforts by focusing on the issues.

19. (D) Opportunity costs, such as lost revenue from a failed trading system, are excluded from the loss database as they do not represent direct losses.
Modern operational risk management encourages the inclusion of both near-misses and opportunity costs in event databases. While opportunity costs, like lost revenue, may not appear as direct profit and loss charges, they represent significant economic impacts and process failures. Excluding them would result in an incomplete risk profile. Therefore, comprehensive databases should capture these events for a full view.

20. (A) Provisions or reserves accounted for in the P&L against the potential operational loss impact.
Gross operational loss computation must capture all financial impacts related to a risk event before any recoveries. This includes any provisions or reserves established in the profit and loss accounts specifically to cover the anticipated loss. Recognizing these financial markers ensures that the dataset accurately reflects the bank's commitment and the identified scale of the operational risk event.

21. (A) (II), (III), (I)
In a typical operational risk event lifecycle, the date of occurrence marks when the actual incident happened. This is followed by the date of discovery, which is when the institution first becomes aware of the event. Finally, the date of accounting is recorded when the financial impact of the event is officially recognized in the bank's financial statements.

22. (B) 5%
For a bank to exclude a specific loss event from its operational risk calculations, the event must meet a defined materiality threshold. Regulatory standards specify that the loss in question must represent more than five percent of the bank's average annual operational losses. This rule ensures that only significant, non-recurring events are considered for exclusion, maintaining the integrity of models.

23. (D) Negative economic impacts booked in a financial accounting period due to operational risk events impacting the cash flows or financial statements of previous accounting periods.
Timing losses refer to negative economic impacts that appear in the current accounting period but are actually related to operational risk events that occurred in previous periods. These losses often involve corrections to past financial statements or adjustments to cash flows that were previously misstated. Including material timing losses ensures that the operational risk database reflects the true historical impact.

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in internal trading controls and oversight processes.

58. (A) Only (I)
Basel risk categories are designed to capture the nature of the risk event itself rather than the underlying cause. This allows for a standardized way to group similar occurrences. The second statement is incorrect because losses caused by a third party with the intent to defraud are classified as external fraud, whereas internal fraud requires the involvement of an internal party.

59. (C) (I), (II), (III), and (IV)
A complete root-cause analysis cycle involves understanding the problem, brainstorming potential causes, performing data analysis to validate those causes, and finally identifying the true root cause. While these steps are fundamental to the investigative process, the deduction of regulatory capital is a separate financial reporting task that occurs after the risk has been identified, measured, and thoroughly analyzed.

60. (A) Only (I) and (II)
Gross loss computation must include all direct financial impacts, such as write-downs and external legal expenses directly related to the event. These represent the immediate costs incurred due to the operational failure. Voluntary upgrades and risk assessment initiatives implemented after the event are considered business enhancements and are excluded from the loss amount as they are not direct impacts.

61. (C) 5-Whys Analysis
The team is utilizing the 5-Whys analysis, a straightforward technique for root-cause identification. By repeatedly asking why a problem occurred, the team can move past the obvious symptoms to find the underlying process or control failure. This iterative questioning helps to quickly reach the core of the issue, facilitating the development of effective and permanent corrective actions for the organization.

62. (A) Opportunity Cost / Lost Revenue
This scenario represents an opportunity cost, which is the revenue the bank could have earned if the system failure had not occurred. While there was no direct out-of-pocket expense or accounting write-down, the lost revenue indicates a significant economic impact from the operational disruption. Tracking such costs provides a more complete picture of the total effect of failures.

63. (B) ₹ 2,50,000
The gross loss is calculated by summing the direct write-down and the external legal expenses directly related to the event. In this case, two lakh rupees plus fifty thousand rupees equals a gross loss of two lakh fifty thousand rupees. General maintenance contracts and insurance premiums are excluded from calculations as they are standard operating costs rather than event-specific impacts.

64. (C) Causal Factor Tree Analysis
Causal Factor Tree Analysis is used to visually represent the various actions and conditions that combined to produce an operational event. By mapping these factors in a logical, tree-like hierarchy, investigators can clearly see the sequence of failures and their interdependencies. This structured approach helps in identifying multiple contributing causes and ensuring that all facets of the incident are investigated.

65. (B) Material "timing losses"
This situation describes timing losses, which are economic impacts recorded in the current period that relate to operational risk events from previous accounting cycles. These often occur when errors in past financial reporting are discovered and corrected. Including material timing losses in the operational risk database is necessary for maintaining an accurate historical record of the bank's operational risk performance.

NODIA

66. (D) No, because the excluded loss event must be greater than 5% of the bank's average losses (i.e., $>$ ₹50 Lakhs).
To exclude a loss based on materiality, the event must exceed five percent of the bank's average annual losses. For Bank A, five percent of ten crores is fifty lakhs. Since the forty-lakh

32. (A) (I), (II), (III), and (IV)
Operational risk events are mapped to Basel categories based on the nature of the event. Hacking is an external fraud, while willful bribes are internal fraud. Missing client permissions belong to process management, and model errors are part of business practices. However, hardware outages are correctly mapped to Business Disruption and System Failures rather than physical asset damage.

33. (B) P-2, Q-1, R-3, S-4
Hacking damage is a classic example of external fraud caused by third parties. Tax evasion by employees is categorized under internal fraud due to the intent to defraud. Fiduciary breaches relate to client relationships and thus fall under business practices. Finally, missed deadlines are operational process failures, mapping directly to the execution, delivery, and process management category in the framework.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Extracting reliable data from news articles is difficult because media outlets do not report events based on risk management priorities. They tend to focus on sensational stories like massive frauds, while ignoring mundane but frequent events like system outages. This creates a skewed dataset that does not accurately represent the actual frequency or variety of operational risks faced by institutions.

35. (A) Only (I)
When a bank seeks to exclude a loss, it must prove that the incident is no longer relevant to its ongoing operations. This requires a clear demonstration to regulators that the risk factors associated with that loss have been eliminated. However, exclusions must still be transparently disclosed; the total amount and number of excluded events are reported under Pillar requirements.

36. (A) Clients, Products, and Business Practices (Suitability, Disclosure, and Fiduciary)
This incident involves a failure to meet professional obligations toward clients regarding product suitability and disclosure. Such events are mapped to Clients, Products, and Business Practices because they stem from the nature of the services provided and the bank's conduct in the marketplace. The core issue is the breach of fiduciary duty and regulatory requirements regarding client interactions.

37. (A) P-2, Q-4, R-1, S-3
Internal fraud includes unauthorized activities like mismarking positions. Employment practices cover issues such as diversity and discrimination in the workplace. The category for clients and products includes fiduciary duties and disclosure suitability. Lastly, execution and process management involves risks related to trade counterparties and processing errors. These mappings ensure consistent classification of operational risk events across different functional areas.

38. (B) (I), (II), and (IV)
Banks are encouraged to capture minor losses to improve risk awareness, with ten thousand rupees being a common internal benchmark. However, the official minimum threshold for the standardized dataset is one lakh rupees. While banks must document their data collection procedures, credit-related operational losses accounted for in credit risk-weighted assets are excluded to avoid double counting of capital.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
In operational risk accounting, the reduction of a gross loss can only occur through actual recoveries. Insurance receivables, while expected, do not represent funds currently held by the bank. Therefore, they cannot be used to offset the loss until the payment is physically received. This rule maintains a conservative and accurate representation of the bank's current financial position.

NODIA

40. (D) Receivables — Counted as recoveries immediately upon identification.
Receivables represent anticipated inflows of cash, but they are not considered recoveries in the operational risk framework until the cash is actually received. Gross losses are calculated before any recoveries, and net losses are calculated after. The principle is that only an actual economic benefit, not a projected one,

(A) They must be completely ignored and excluded from all internal databases until they are legally settled or the investigation is closed.
(B) Material pending losses shall be included in the loss data set within a time period commensurate with the size and age of the pending item.
(C) They are treated as external fraud events due to their uncertain nature and the lack of a finalized P&L entry at the time of discovery.
(D) They are classified strictly as near-misses until they are removed from the suspense account and recognized as a realized loss.

May/June 2013

70. A bank is about to implement a new core banking software. Before the rollout, the operational risk team systematically evaluates the possible risk impacts and devises appropriate management strategies for this specific situation where operating practices are being revised. Which RCA-related proactive method does this describe?
(A) Barrier Analysis
(B) Change Analysis
(C) Fault Tree Analysis
(D) Fish-Bone Diagram

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49. (B) (I), (II), (III), and (V)
Gross loss computation includes timing losses, pending losses in suspense accounts, and costs to restore the original position. External expenditures for business enhancement after an event are excluded because they are voluntary upgrades. However, general maintenance contracts are also excluded as they represent standard operating expenses rather than direct impacts of a risk event, making statement four incorrect.

50. (C) Only (I) and (III)
External loss data is highly valuable for scenario analysis as it helps banks understand risks they haven't yet experienced. Providers like ORX and FIRST facilitate this by sharing industry-wide data. Senior management is deeply interested in these events because they signal emerging industry trends and potential vulnerabilities that could eventually impact the firm's own balance sheet and operations.

51. (D) The financial impact is not an operational loss of the bank and therefore shall not be included in the dataset.
If a third-party vendor completely reimburses a bank for a loss caused by their own error, the bank has not suffered a direct financial impact. Under regulatory guidelines, such incidents are not recorded as operational losses of the bank. While the bank may track the event for vendor management purposes, it does not enter the primary operational risk database.

52. (D) Market manipulation — Clients, Products, and Business Practices.
Market manipulation is a conduct-related issue that falls under the Clients, Products, and Business Practices category. This is because it involves improper business practices that affect market integrity or client interests. In contrast, malicious destruction of assets is part of physical asset damage, and check kiting is a form of fraud. Proper pairing is essential for accurate reporting.

53. (B) Only (II)
Regulatory standards require that operational risk losses related to market risk be included in the loss database to ensure comprehensive coverage. However, foreign currency losses are not necessarily converted at the rate on the date of occurrence. Instead, they should be converted using the exchange rate applied in the financial statements for the period when the loss was accounted.

54. (D) Assertion (A) is false, but Reason (R) is true.
While Basel standards do promote the comprehensive capture of material activities, there is a specific exception for credit risk. Operational losses that are already accounted for in the calculation of credit risk-weighted assets are excluded from the operational risk dataset to prevent double counting of capital requirements. Therefore, the assertion that all credit-related operational losses must be included is incorrect.

55. (C) (I), (II), and (IV)
Excluding an operational loss requires regulatory approval and must meet a materiality threshold, specifically being greater than five percent of the bank's average losses. These exclusions must also be disclosed under Pillar 3. The third statement is incorrect because the standard minimum retention period in the operational risk database before considering exclusion is three years, rather than five years.

56. (A) P-1, Q-2, R-4, S-3
Direct charges to profit and loss accounts and material pending losses in suspense accounts are mandatory inclusions in the gross loss computation. Conversely, standard business expenses such as general maintenance contracts and insurance premiums are excluded. This distinction ensures that the dataset focuses on the direct financial impacts of operational failures rather than routine operational costs or risk transfer payments.

57. (A) Level 1: Internal Fraud; Level 2: Unauthorized Activity
When an employee intentionally bypasses controls or misreports data to deceive the bank, it is classified as internal fraud. Specifically, mismarking positions falls under the Unauthorized Activity sub-category. This mapping reflects the internal nature of the actor and the specific type of misconduct, allowing the bank to identify and address weaknesses

NODIA

24. (D) The date the regulatory authority officially closed the investigation of the event.
Banks must track specific internal dates for every operational risk event, including the dates of occurrence, discovery, and accounting. These markers are essential for calculating risk metrics and ensuring data quality. However, the date a regulatory authority closes its own external investigation is not a mandatory requirement for the bank's internal loss dataset, as it pertains to external oversight.

25. (B) Improper Business or Market Practices - Retail customer disclosure violations
The categorization of operational risk events requires precise mapping to Basel levels. Retail customer disclosure violations are correctly mapped under the Suitability, Disclosure, and Fiduciary category rather than Improper Business or Market Practices. This distinction is important for identifying the specific nature of the failure, whether it relates to client interactions or broader market conduct rules and ethical standards.

26. (D) A structured investigation that aims to identify the true cause of a problem and the actions necessary to eliminate it.
Root cause analysis is a methodical investigative process designed to find the fundamental reason for a failure. Unlike simple troubleshooting, it seeks to identify why an event occurred so that permanent solutions can be implemented. By eliminating the root cause, organizations can prevent the recurrence of the problem, thereby improving overall operational stability and reducing long-term risk exposure.

27. (A) It perceives threat and builds resilience against operational risks by providing insight into risks faced and offering sample inputs for scenario analysis.
External loss data provides institutions with a broader perspective on potential operational threats that they may not have experienced internally. By reviewing industry-wide incidents, banks can identify emerging risks and vulnerabilities. This information serves as a crucial input for scenario analysis and stress testing, allowing the bank to build resilience by proactively strengthening controls against identified risk patterns.

28. (A) Operational loss events related to credit risk that are accounted for in credit RWA shall not be included, but those not accounted for in credit RWA shall be included.
To avoid double counting, operational losses that are already captured within the calculation of credit risk-weighted assets are excluded from the operational risk dataset. However, if a credit-related operational loss is not accounted for in the credit risk framework, it must be included in the operational risk loss database. This ensures comprehensive coverage of all operational failures.

29. (D) Insider trading (not on firm's account)
Internal fraud involves acts intended to defraud or circumvent the law by at least one internal party. While unauthorized transactions or check kiting fit this description, insider trading that does not involve the firm's own account is categorized differently. Specifically, such market-related misconduct is mapped under Clients, Products, and Business Practices, as it involves improper practices rather than fraud.

30. (D) A bank shall collect the "date of occurrence", the "date of discovery", and the "date of accounting".
Accurate record-keeping for operational risk requires the documentation of three specific dates for every event. The bank must record when the event happened, when it was first identified, and when its financial impact was officially recognized in the accounting records. Collecting all three dates provides a complete timeline of the incident, which is vital for data analysis and reporting.

31. (C) Fault Tree Analysis — The event is placed at the root (top event) of a "tree of logic".
Fault Tree Analysis is a top-down investigative method where a specific undesirable event is analyzed using Boolean logic to identify all possible causes. The main event is placed at the top of a tree structure, and various contributing factors are branched out below it. This visual and logical representation helps investigators understand how different system failures combine to cause incidents.

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loss is below this threshold, it does not meet the regulatory criteria for exclusion, regardless of its connection to a divested business unit or activity.

67. (D) Pareto Analysis
The bank is using Pareto Analysis, which is based on the 80/20 rule. This principle states that roughly eighty percent of effects come from twenty percent of causes. By identifying that a few software glitches are responsible for the vast majority of errors, the bank can efficiently prioritize its resources to fix those specific issues, leading to significant risk reduction.

NODIA

68. (A) Barrier Analysis
Barrier Analysis is used to identify how a hazard reached its target by passing through or around established controls or barriers. In this case, the team is investigating why the cooling system failed during a power surge, focusing on which protective measures were missing or ineffective. This method helps in strengthening physical and process-based defenses to prevent similar failures.

69. (B) Material pending losses shall be included in the loss data set within a time period commensurate with the size and age of the pending item.
Material pending losses recorded in suspense accounts represent identified financial impacts that have not yet been finalized. Regulatory guidelines require these to be included in the loss database once they are considered material. The timing of their inclusion should reflect the significance and duration of the item, ensuring that the operational risk profile remains current even during investigations.

70. (B) Change Analysis
Change Analysis is a proactive root-cause analysis technique that examines the potential risks introduced by modifications to systems, policies, or configurations. By systematically evaluating what has changed and how those changes might lead to new vulnerabilities, the bank can implement strategies to mitigate those risks before the new software is fully rolled out, ensuring a smoother and safer transition.

CHAPTER 19

Risk and Control Self-Assessment & Key Risk Indicator

Oct/Nov 2014

1. How is inherent risk defined in the context of operational risk management?

(A) The mathematical probability that financial statements are materially misstated due to the failure of secondary control layers.

(B) The comprehensive assessment of the level of risk exposure assuming that all internal controls are functioning perfectly at all times.

(C) The aggregate level and types of risk an organisation is willing to assume to achieve its strategic objectives and long-term business goals.

(D) The risk in an activity or product in the absence of any management mitigation plans or actions.

May/June 2023

2. Match the Control Design Effectiveness scale (List I) with its corresponding description (List II):

List I: (Control Design Effectiveness)

P. Effective

Q. Meets Requirements

R. Highly Effective

S. Improvement Needed

List II: (Description)

1. Automated / Well Controlled / Detective
2. Semi-Automated and Detective
3. Semi-Automated and Preventive
4. Manual / Non-Preventive

(A) P-2, Q-3, R-1, S-4

(B) P-1, Q-4, R-2, S-3

(C) P-3, Q-1, R-4, S-2

(D) P-4, Q-2, R-3, S-1

Oct/Nov 2022

3. Arrange the following phases of the RCSA process in their correct prescribed chronological order:

I Identify the inherent risks arising from products and activities.

II Rate the overall quality of the control environment for each business line.

III Identify key process owners and staff involved in the process to participate in workshops.

IV Assess the remaining levels of risk after applying existing controls.

(A) III, I, II, IV

(B) I, III, II, IV

(C) III, II, I, IV

(D) II, I, III, IV

May/June 2016

4. Which of the following is a correct statement regarding the Risk Management Matrix combining Probability and Services impact?

(A) A probability of 'Frequent (A)' combined with a 'Negligible (4)' service impact yields a 'Low' risk level.

(B) A probability of 'Remote (D)' combined with a 'Critical (2)' service impact yields a 'Serious' risk level.

(C) A probability of 'Occasional (C)' combined with a 'Marginal (3)' service impact yields a 'Medium' risk level.

(D) A probability of 'Improbable (E)' combined with a 'Catastrophe (1)' service impact yields a 'High' risk level.

Oct/Nov 2009

5. Likelihood scales for the occurrence of risk events are most commonly defined in terms of which metric?

(A) The specific dollar amount impacted by a failure per financial quarter in a given business line.

(B) Timeframes such as occurring a specific number of times per year.

(C) The fixed percentage of Minimum Regulatory Capital (MRC) allocated for

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each specific risk event.

(D) The number of independent automated controls failing simultaneously within a single reporting cycle.

May/June 2007

6. How is a Key Risk Indicator (KRI) strictly defined in the context of bank management?

(A) An absolute limit of authority beyond which subordinates must immediately escalate for senior management approval before proceeding.

(B) A quantifiable measurement evaluating potential operational risk exposure and its impact on various areas.

(C) An unquantifiable cultural assessment tool applied by external auditors to judge the subjective morale of an organization.

(D) A theoretical model used exclusively by quantitative analysts to forecast market risk capital requirements for trading books.

Oct/Nov 2025

7. What is the primary objective of the Risk Control and Self-Assessment (RCSA) framework in a bank?

(A) To eliminate all operational risk exposures and bypass mandatory regulatory compliance activities across all jurisdictions.

(B) To estimate operational risk and internal control effectiveness.

(C) To replace the independent internal audit function with a decentralized peer-review system managed by junior staff.

(D) To focus exclusively on market and credit risk vulnerabilities while ignoring the impact of operational failures across business units.

May/June 2012

8. Identify the correct pair representing the computation of the Risk Product associated with a product or business line:

(A) Scale of Frequency + Scale of Severity

(B) Scale of Frequency x Scale of Severity

(C) Control Design Effectiveness x Scale of Frequency

(D) Control Operating Effectiveness + Scale of Severity

Oct/Nov 2018

9. Identify the incorrect statement regarding the computation in the study of effectiveness of control:

(A) RCSA must include an assessment of the controls put in place to address the causes and effects of operational risk events.

(B) Control Product is estimated by adding the design and operating effectiveness scales.

(C) Assessments of control effectiveness use an ordinal scale system similar to those used for measuring probability and impact.

(D) Control Product is calculated by multiplying the score for Control Design Effectiveness by the score for Control Operating Effectiveness.

May/June 2019

10. Consider the following statements regarding the impact study within inherent risk assessment:

I Impact study involves the rating of potential loss involved in the products, process, or business lines.

II Most impact ratings use a ten-point scale, ranging from insignificant to catastrophic.

III Relative definitions of impact scales are adaptable to risk assessment units of different sizes.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II) are correct

(B) Only (II) and (III) are correct

(C) Only (I) and (III) are correct

(D) All (I), (II), and (III) are correct

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Oct/Nov 2006

11. Identify the correct pair representing the three different types of indicators typically used by an organization for operational risk management:

(A) Lagging indicators of past events, Leading indicators of future trends, and Static indicators for fixed baseline assets.

(B) Qualitative indicators based on surveys, Quantitative indicators based on counts, and Hybrid indicators combining both metrics.

(C) Strategic indicators for long-term goals, Market indicators for price volatility, and Credit indicators for counterparty default

May/June 2008

36. Consider the following key questions investigated when an organization's operational risk exposures are stressed:

I Will controls remain effective and what if any controls might fail?

II What would be the financial and reputational impacts of such events?

III Can these impacts be mitigated during the event?

IV Might additional controls be required to help reduce the probability and/or impact of stress events?

Which of the above statement(s) is/are correct?

(A) Only (I), (II), and (III) are correct
(B) Only (II), (III), and (IV) are correct
(C) Only (I), (III), and (IV) are correct
(D) All statements are correct

Oct/Nov 2013

37. Identify the incorrect statement describing the various forms of Key Risk Indicators:

(A) Performance indicators are metrics that measure the achievement of targets but are entirely inapplicable to operational risk reduction.
(B) A risk exposure indicator provides information on the level of exposure to a given operational risk at a particular point in time.
(C) As customer complaints increase, the value of the risk exposure indicator is likely to be associated with changes in operational loss experience.
(D) Control effectiveness indicators provide information on the extent to which a given control is meeting its intended objectives.

May/June 2015

38. All of the following are examples of "Process related" illustrative Key Risk Indicators EXCEPT:

(A) Disproportionate number of unsettled suits filed cases
(B) Significant variation in internal credit rating and external agency rating of same borrowers
(C) Screening system not capturing suspicious transactions or money laundering attempts
(D) Unreasonable transaction–staff ratio

Oct/Nov 2012

39. The Board of Directors issues a policy explicitly stating that operating within specific sanctioned countries and providing poor customer service are behaviors deemed strictly unacceptable, regardless of financial targets. This action is a direct application of which risk framework element?

(A) Scenario analysis threshold matching tests.
(B) Quantitative expressions of risk tolerance.
(C) Lagging performance indicator mapping tools.
(D) Qualitative risk appetite expressions.

May/June 2011

40. Consider the following statements regarding the approaches to KRI selection processes:

I The top-down approach starts with senior management and/or directors selecting the indicators that are to be monitored across the business.

II The bottom-up approach allows business entity managers to select and monitor their own sets of indicators most relevant to their situation.

Which of the above statement(s) is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2020

41. A large commercial bank wants to use the Advanced Measurement Approach (AMA) to calculate operational risk capital. To justify the use of forward-looking measures, what specific criteria must the chosen indicator factors meet?

(A) They must be exclusively qualitative and avoid reflecting any translatable numerical data for reporting purposes.
(B) They must be meaningful risk drivers and translatable into verifiable quantitative measures.
(C) They must ensure an explicit relationship solely with trailing financial audit reports from previous fiscal years.
(D) They must reflect a backward-looking perspective limited only to internal fraud events and employee misconduct.

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to mitigate risk.
(B) It represents the ideal target risk level an organization strives to reach after all mitigation strategies are fully deployed.
(C) It represents the exact amount of regulatory capital the bank must hold for operational risk under the basic indicator approach.
(D) It represents the net risk determined after the scores for control design and operating effectiveness are calculated by the unit.

Oct/Nov 2007

19. Match the Control Operating Effectiveness scale (List I) with its corresponding description (List II):
List I: (Control Operating Effectiveness)
P. Meets Requirements
Q. Highly Effective
R. Improvement Needed
S. Effective
List II: (Description)
1. Well Controlled / No Failure
2. Rare Control Failure
3. Control Failure frequently with no major loss
4. Control Exists but fails regularly
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2025

20. During a risk assessment workshop, a business unit identifies that a specific risk event has occurred 6 times over the past year. According to the standard 5-point likelihood scale, how should this frequency of occurrence be qualitatively rated?
(A) Rare
(B) Moderate
(C) Likely
(D) Frequent

Oct/Nov 2019

21. According to the operational risk framework, when does a standard piece of data or indicator transition into becoming a "key" risk indicator?
(A) When it is officially approved by the external regulatory authority for mandatory use in capital charge computation cycles.
(B) When it demonstrates zero statistical variance over a consecutive five-year strategic horizon during internal stress testing.
(C) When it tracks an especially important risk or best captures its potential exposure.
(D) When it measures only the direct financial return on risk-adjusted capital for a specific high-value business unit.

May/June 2009

22. Consider the following statements regarding the implementation of RCSA:
I A well-designed RCSA can help embed operational risk management across an organization and improve management attitudes.
II Weaknesses or gaps in controls identified via RCSA can decrease the chance of system failures and the impact of external events.
Which of the above statement(s) is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2011

23. A bank calculates the operational risk severity for a specific loss event. The Net Loss Range is determined to be 0.5% of the Minimum Regulatory Capital (MRC). Based on standard impact rating scales, what is the assigned severity rating and qualitative descriptor for this event?
(A) 2 (Minor)
(B) 4 (Major)
(C) 3 (Moderate)
(D) 5 (Catastrophic)

May/June 2010

24. Based on the Computation of Risk Zone framework, which of the following is NOT a designated Risk Zone category assigned to branches based on their risk scores?
(A) Critical
(B) High
(C) Medium
(D) Minor

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Oct/Nov 2024

25. Consider the following statements regarding the definition and application of likelihood in RCSA:

I General practice has evolved from a 5-point scale to rate the likelihood of occurrence of loss events.

II The sequence of events is not considered important when qualifying the risks.

III 'Unlikely' describes an event that may occur in exceptional circumstances and has not occurred yet, but the possibility should be watched.

IV 'Frequent' indicates that the event is more likely to happen many times in a year.

Which of the above statement(s) is/are correct?

(A) Only (I), (II), and (III) are correct
(B) Only (II), (III), and (IV) are correct
(C) Only (I), (III), and (IV) are correct
(D) All statements are correct

May/June 2017

26. What is residual risk also known as in the context of an assessment of risk exposure?

(A) Gross risk
(B) Inherent risk
(C) Absolute risk
(D) Net risk

Oct/Nov 2005

27. A bank evaluates a specific IT service failure scenario. The service impact is rated as 'Critical (2)' and the probability of occurrence is rated as 'Probable (B)'. According to the color-coded Risk Management Matrix, what is the final categorized risk level?

(A) Medium
(B) High
(C) Low
(D) Serious

May/June 2020

28. Match the Rating Scale for Impact Study (List I) with its corresponding severity parameter expressed as Net Loss Range as % of Minimum Regulatory Capital (List II):

List I: (Rating Scale for Impact Study)

P. Insignificant
Q. Major
R. Minor
S. Moderate

List II: (Net Loss Range as % of Minimum Regulatory Capital)

1. $0 \leq x < 0.01\%$
2. $0.01\% \leq x < 0.1\%$
3. $0.1\% \leq x < 1\%$
4. $1\% \leq x < 10\%$

(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2015

29. A transaction monitoring control is evaluated during an RCSA. Its design is classified as "Semi-Automated and Preventive", but operational testing reveals that the "Control Exists but fails regularly". Based on the standard 5-point rating scales, what are the numeric values for its Control Design Effectiveness and Control Operating Effectiveness respectively?

(A) 3 and 4
(B) 2 and 5
(C) 4 and 3
(D) 3 and 5

May/June 2013

30. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Mark the correct choice:

Assertion (A): Building a likelihood metrics is very tricky unless its regularity is well captured and processed.

Reason (R): Workshop facilitators should ensure that all participants in the risk assessment use the same definitions to avoid conflicting interpretations.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2021

31. Consider the following statements outlining the desirable criteria of an Effective KRI System:

I Indicators must have relevance to what

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is being monitored, such as linking risk indicators to operational risk exposures.

II Indicators must be capable of being measured with a high level of certainty and on a repeated basis.

III Risk indicators can provide a leading, lagging, or current perspective of an organization's operational risk exposures.

IV The data used for the indicator should be highly complex and expensive to collect to ensure maximum accuracy.

V An independent validation of the indicator selection process should be undertaken by the internal audit function.

Which of the above statement(s) is/are correct?

(A) Only (I), (II), (III), and (IV) are correct
(B) Only (I), (II), (III), and (V) are correct
(C) Only (II), (III), (IV), and (V) are correct
(D) All statements are correct

May/June 2024

32. Consider the following statements regarding the reinforcement messages of qualitative expressions of appetite or tolerance:

I It is sensible to accept operational risks where the cost of mitigation/avoidance exceeds the expected loss, provided there is no risk of bankruptcy.

II Risks will be accepted when the estimated losses are within prescribed tolerance levels.

III Behaviours such as knowingly breaking the law or breaching regulatory requirements are deemed acceptable if they generate short-term profit.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II) are correct
(B) Only (II) and (III) are correct
(C) Only (I) and (III) are correct
(D) All (I), (II), and (III) are correct

Oct/Nov 2008

33. All of the following are examples of operational risk related Performance Indicators (KPIs) EXCEPT:

(A) Cumulative hours of IT system outage across all critical customer-facing platforms.
(B) Cases of customer identity misrepresentation.
(C) Percentage of products or transactions containing critical faults or recurring processing errors.
(D) Percentage of automated processes requiring manual intervention due to technical logic failures.

May/June 2006

34. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Mark the correct choice:

Assertion (A): Reverse stress testing involves identifying the point of non-viability, such as determining the maximum financial loss an organisation can withstand.

Reason (R): Reverse stress testing events usually occur much more frequently than standard common scenarios and have a significantly lower impact.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2017

35. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Mark the correct choice:

Assertion (A): A "repetitive touch" trigger initiates an immediate alert and escalation the very first time the boundary is reached.

Reason (R): Triggers should be linked to risk appetite and take into account the resource overhead necessary to implement more sophisticated structures.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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Which of the above statement(s) is/are correct?
(A) Only (I), (II), (III), and (IV) are correct
(B) Only (II), (III), (IV), and (V) are correct
(C) Only (I), (III), (IV), and (V) are correct
(D) All statements are correct

May/June 2007

48. Which of the following statements most appropriately describes the "Comparable" characteristic of a good indicator?
(A) The data should be relatively easy to interpret and understand without the need for any external validation by auditors.
(B) Metrics requiring a benchmark, such as percentages or ratios, to provide meaningful context.
(C) The indicator must be described primarily by subjective text rather than by objective mathematical numbers or counts.
(D) The indicator must strictly capture historical events and past failures to ensure a high level of quality assurance.

Oct/Nov 2025

49. Which of the following is a correct statement identifying the nature of quantitative expressions of risk appetite?
(A) They tend to be risk-specific and serve as an indication of tolerance rather than overall appetite.
(B) They rely entirely on written policy statements that do not involve any mathematical metrics or statistical benchmarks.
(C) They are only applicable to strategic risk and completely ignore operational performance indicators during the assessment.
(D) They cannot incorporate thresholds set on an aggregate basis for operational risks across multiple geographical locations.

May/June 2012

50. A bank's ongoing monitoring reveals a "rapid increase in number of loan accounts" and "frequent revisions in credit rating of borrowers." According to the framework of illustrative KRIs, which specific risk source do these indicators fall under?
(A) Process related
(B) System related
(C) Operations related
(D) People related

Oct/Nov 2018

51. Identify the incorrect statement regarding the uses of Key Risk Indicators (KRIs):
(A) Indicators can be used to track changes in an organization's exposure to operational risk and enable systemic monitoring.
(B) Trends in indicators provide an indication of whether an organisation's exposure to a particular risk is increasing or decreasing.
(C) Indicators that breach pre-assigned thresholds or limits may signal a significant change in risk that requires prompt action.
(D) Systemic monitoring of risks through KRIs completely eliminates the necessity of establishing a risk appetite framework.

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May/June 2019

52. A bank's risk department wants to deploy a measure that acts as a preventive action, offering predictive power regarding the likelihood of future unwanted events. Which classification of metric should they implement?
(A) Lagging indicator
(B) Trailing historical indicator
(C) Retroactive control indicator
(D) Leading KRI

Oct/Nov 2006

53. Conceptually, what is the primary purpose of setting a threshold or limit for a monitored risk indicator?
(A) To ensure that the independent internal audit department signs off on the validity of every individual data source.
(B) To measure the absolute historical financial loss caused by an event over a fixed five-year rolling strategic horizon.
(C) To establish boundaries that alert the organization to a significant change in risk exposure.
(D) To automatically initiate mandatory regulatory capital charge adjustments under the specific rules of Basel II.

May/June 2021

54. Why is scenario analysis considered an important way to assess operational risk despite the existence of loss databases?
(A) Because historical data guarantees that

May/June 2022

42. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Mark the correct choice:
Assertion (A): A true KRI will be a leading indicator that attempts to predict points of emerging risk before unwanted events happen.
Reason (R): Leading indicators include measures of effectiveness of preventive controls which are predictive in terms of the likelihood of a given risk event.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2023

43. Which of the following is the most appropriate distinction regarding the use of qualitative expressions of risk appetite?
(A) They involve hard data rooted entirely in quantitative business management information systems used for financial forecasting.
(B) They are useful for hard-to-quantify risks and reinforce specific risk culture behaviors.
(C) They are primarily an indication of operational risk tolerance expressed on a per-event dollar basis for budget cycles.
(D) They are utilized exclusively to calculate the Advanced Measurement Approach (AMA) capital requirement under Basel II standards.

May/June 2023

44. Match the Illustrative Key Risk Indicator (List I) with its corresponding Operational Risk Source (List II):
List I: (Key Risk Indicator)
P. Unusual duration of systems downtime
Q. Frequent entries in staff deposit accounts
R. Disproportionate number of unreconciled entries in books of accounts
S. Clubbing of conflicting responsibilities
List II: (Operational Risk Source)
1. People related
2. Operations related
3. Process related
4. System related
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2014

45. A regional bank decides to evaluate how an extreme pandemic wave and an accompanying economic recession might impact its operations across multiple risk factors. What type of operational risk assessment does this represent?
(A) Residual risk computation
(B) Routine impact study parameter scaling
(C) Standard stress testing
(D) Escalation trigger validation

May/June 2016

46. A financial institution tracks the "number of network user access rights not reviewed within a specific period." What specific type of indicator does this metric represent?
(A) Performance Indicator for operational efficiency.
(B) Control Effectiveness Indicator.
(C) Risk Exposure Indicator for internal security.
(D) Lagging Market Indicator for external trends.

Oct/Nov 2009

47. Consider the following benefits and inclusions of scenario analysis and stress testing:
I Enabling management to test the resilience of their organisation in relation to major operational risk events.
II Providing a forward-looking perspective by focusing on future operational risk events that may differ from the past.
III Complementing other risk identification techniques such as loss event analysis and risk and control self-assessment.
IV Offering a break from day-to-day risk management to help managers think creatively about future risks.
V Improving the control environment where potential gaps or weaknesses are identified as part of the analysis.

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risk.
(D) Risk, Control Effectiveness, and Performance indicators.

May/June 2021

12. A retail branch manager begins assessing the risk of a new financial product by estimating the worst-case scenario potential loss, assuming all internal controls put in place have completely failed. Which specific type of risk is the manager evaluating?
(A) Residual risk
(B) Mitigated risk
(C) Inherent risk
(D) Net risk

Oct/Nov 2010

13. Assessing the effectiveness of a control system under the RCSA process is done with respect to which two specific aspects?
(A) Design effectiveness and operational effectiveness
(B) Financial effectiveness and regulatory effectiveness
(C) Qualitative effectiveness and quantitative effectiveness
(D) Lagging effectiveness and leading effectiveness

May/June 2005

14. Identify the incorrect pair regarding the qualitative rating and its corresponding frequency of occurrence on the Likelihood Scale:
(A) Rare — An event that occurs only once in a period exceeding 5 years.
(B) Unlikely — An event that occurs once in a period of more than 1 year up to 5 years.
(C) Moderate — An event that occurs exactly once in a single calendar year.
(D) Likely — Over 10 times per year

Oct/Nov 2022

15. Consider the following statements regarding corrective action plans for operational risk mitigation:
I Agreed actions must be Specific, Measurable, Achievable, Realistic and Timebound (SMART).
II Actions should be assigned to an owner, usually a manager with the necessary seniority to ensure completion.
III The corrective action plan must include the name of the business line and a clear description of each control weakness.
IV Risk level beyond risk appetite (Red zone) must be subject to a risk mitigation action plan.
V The manager responsible is no longer required to monitor corrective actions once a target date for resolution is documented.
Which of the above statement(s) is/are correct?
(A) Only (I), (II), (III), and (IV) are correct
(B) Only (II), (III), (IV), and (V) are correct
(C) Only (I), (III), (IV), and (V) are correct
(D) All statements are correct

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May/June 2018

16. Which of the following best describes the dynamic and iterative features of an effective RCSA system?
(A) It tracks corrective actions continuously, adapts to new controls, and applies at unit and institutional levels.
(B) It relies on a static, one-time assessment matrix that is implemented strictly at the highest corporate level without local input.
(C) It remains completely static once initial controls are introduced to ensure consistent historical benchmarking for external reporting.
(D) It only tracks operational risk capital requirements without assessing the effectiveness of the underlying internal control environment.

Oct/Nov 2016

17. A business unit calculates its Risk Product as 15 and its Control Product as 3. Using the standard Risk Profile Matrix logic, what is the total Risk Score and into which Risk Zone does this unit fall?
(A) Score 45; Low
(B) Score 18; Minor
(C) Score 45; Medium
(D) Score 80; Medium

May/June 2014

18. Which of the following is the most appropriate interpretation of what inherent risk represents?
(A) It shows a worst-case scenario where all internal controls put in place have failed

historical trends will repeat themselves exactly as they occurred in the past.
(B) Because it completely eliminates the need for calculating residual risk in top-down KRI mapping within the business.
(C) Because historical data is often limited and doesn't guarantee future trends will repeat.
(D) Because scenario analysis relies purely on the automated outputs of screening systems without human intervention.

Oct/Nov 2010

55. How is Risk Appetite defined within the operational risk framework?
(A) The level and types of risk an organisation is willing to assume to achieve its strategic objectives.
(B) The point of non-viability determining the maximum financial loss that an organisation can withstand before total failure.
(C) The residual risk left after applying qualitative parameters to historical loss data matrices for regulatory reporting.
(D) The probability that financial statements are materially misstated due to business failures and reporting inaccuracies.

May/June 2005

56. Which of the following conceptually describes the nature and utility of Lagging KRIs?
(A) Historical measures that track past activity and show what has already happened.
(B) Measures considered predictive in nature that attempt to identify points of emerging risk before they fully manifest.
(C) Metrics that dictate the level of control effectiveness before any specific preventive actions are actually deployed.
(D) Tools that directly evaluate the future probability of occurrence of a given risk event based on external market data.

Oct/Nov 2011

57. A bank's risk analysts set a maximum financial loss threshold that would cause the institution to declare bankruptcy. They then analyze internal risk events, such as a major IT failure or fraud, that could cause losses exceeding this exact value. Which specific assessment methodology are the analysts utilizing?
(A) Reverse stress testing
(B) Top-down KRI assessment
(C) Control design effectiveness rating
(D) Lagging indicator trend analysis

May/June 2018

58. Arrange the following steps of the KRI Identification process in their correct prescribed chronological order:
I Identify KRIs via risk control self-assessment (RCSA) — interview business units.
II Concentrate on the significant risks and their causes and consider forward looking and historical indicators.
III Consider absolute values and numbers, ratios, percentages, ageing, etc.
IV Collate data on KRIs on a systematic and consistent basis in order to be meaningful.
(A) I, II, III, IV
(B) II, I, IV, III
(C) III, I, II, IV
(D) IV, III, II, I

Oct/Nov 2016

59. A retail banking division formally establishes that "based on budgeting, an adverse trend of 5% in aggregate annual loss is acceptable, 10% is tolerable, but 15% is unacceptable." What specific operational framework element is the division implementing?
(A) Delegated limits of financial authority.
(B) Qualitative measures of process reliability.
(C) Risk tolerance metrics.
(D) Escalation triggers for non-compliance.

May/June 2014

60. Match the Illustrative Key Risk Indicator (List I) with its corresponding Operational Risk Source (List II):
List I: (Key Risk Indicator)
P. Adverse age profile of executives
Q. High proportion of incomplete and expired loan documents
R. Frequent violation of security codes
S. Significant number of unpaid clearing checks
List II: (Operational Risk Source)
1. System related
2. People related
3. Process related
4. Operations related

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ANSWERS

1. (D) The risk in an activity or product in the absence of any management mitigation plans or actions.
Inherent risk represents the level of exposure to risk that exists in the absence of any management controls or mitigation efforts. It focuses on the fundamental riskiness of a specific activity or product before any preventive or detective measures are implemented. Assessing this risk allows organizations to understand the maximum potential impact of failures.

2. (A) P-2, Q-3, R-1, S-4
Control Design Effectiveness is measured using a standardized scale that links specific control characteristics to qualitative ratings. Highly effective controls are typically automated and preventive. Effective controls are automated and detective, while systems meeting requirements are semi-automated and preventive. Controls needing improvement are generally manual and non-preventive, reflecting a higher degree of residual risk.

3. (A) III, I, II, IV
The Risk Control Self-Assessment process begins with identifying key process owners and staff for workshops. Subsequently, inherent risks arising from specific products and activities are identified. The next step involves rating the overall quality of the control environment for each business line. Finally, the remaining levels of residual risk are assessed after accounting for existing controls.

4. (C) A probability of 'Occasional (C)' combined with a 'Marginal (3)' service impact yields a 'Medium' risk level.
The risk management matrix evaluates the intersection of probability and service impact to determine the overall risk level. Under this framework, an occasional probability rating paired with a marginal impact level results in a medium risk classification. This approach helps organizations prioritize risks by visualizing how frequently an event might occur alongside the severity of its potential consequences.

5. (B) Timeframes such as occurring a specific number of times per year.
Likelihood scales in operational risk management are primarily defined using time-based metrics or frequency counts within a specific period. These definitions help standardize the assessment of how often a risk event is expected to occur. Common intervals used include annual frequencies, such as events occurring once per year or several times within a five-year strategic planning window.

6. (B) A quantifiable measurement evaluating potential operational risk exposure and its impact on various areas.
Key Risk Indicators are quantifiable measurements used by bank management to monitor and evaluate potential operational risk exposures. These indicators provide early warning signs by tracking changes in risk levels across different functional areas. By measuring specific variables, KRIs allow for a proactive approach to risk management, highlighting where potential impacts might exceed the established organizational risk appetite.

7. (B) To estimate operational risk and internal control effectiveness.
The primary objective of the Risk Control and Self-Assessment framework is to provide a structured method for estimating operational risk and evaluating the effectiveness of internal controls. This process encourages business units to identify vulnerabilities and assess how well their current mitigation strategies are performing. It ensures that risks are managed consistently and aligned with the bank's overall objectives.

8. (B) Scale of Frequency x Scale of Severity
In operational risk management, the risk product is computed by multiplying the scale of frequency by the scale of severity. Frequency represents the likelihood of a risk event occurring, while severity measures the potential impact or loss resulting from that event. This calculation provides a quantitative

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following is NOT one of those valid designated purposes?

(A) To control risk so that it remains within risk appetite.
(B) To impose discipline.
(C) To ensure corporate target is achieved.
(D) To explicitly punish miscreants.

May/June 2020

68. Consider the following summary statements regarding Key Risk Indicators:

I KRIs are prepared in terms of risk exposure indicator, control effectiveness indicator, and performance indicator.
II KRIs can be a lag KRI or it can be a lead indicator.
III Lag indicators are predictive in nature, while lead KRIs mostly depend on historical measures.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II) are correct
(B) Only (II) and (III) are correct
(C) Only (I) and (III) are correct
(D) All (I), (II), and (III) are correct

Oct/Nov 2015

69. Consider the following statements regarding risk metrics:

I Control risk is the probability that financial statements are materially misstated, due to failures in the controls used by a business.
II Leading KRIs are measures that are considered predictive in nature.

Which of the above statement(s) is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2013

70. Escalation triggers are structurally associated with which of the following elements?

(A) Business performance metrics exclusively
(B) Key Risk Indicators (KRI)
(C) Risk management effectiveness audits
(D) Macroeconomic stress testing scenarios

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(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2007

61. Identify the incorrect statement regarding the principles of setting risk thresholds:
(A) Once KRIs are identified, the bank needs to set a risk threshold which will trigger different levels of response depending on severity.
(B) Operational Risk Management (ORM) can be made sharper and more effective if the thresholds of KRIs are fixed based on risk event experiences.
(C) It vitiates the purpose of ORM if the frequency of their occurrences is correctly captured and comprehensively recorded.
(D) There is no point in setting risk thresholds if the frequency of risk event occurrences is not correctly captured.

May/June 2025

62. Identify the incorrect pair regarding operational risk definitions:
(A) Risk Appetite — Metrics based entirely on historical measures.
(B) Residual Risk — Assessment of the level of risk exposure with controls in place.
(C) Inherent risk — Risk present in an activity, product and function in the absence of any mitigation plans.
(D) Control Risk — The probability that financial statements are materially misstated due to control failures.

Oct/Nov 2019

63. Which of the following is the most appropriate reason why scenario analysis, stress, and reverse stress testing are often used to supplement internal and external loss data when constructing statistical models for operational risk?
(A) Because historical internal and external loss data is purely predictive and never requires validation.
(B) Because historical data represents the fullest possible range of forward-looking probability outcomes on its own.
(C) Because internal and external loss data is historical and is often incomplete.
(D) Because external loss data is strictly prohibited from being used under regulatory guidelines.

May/June 2009

64. Which of the following represents the correct nature of Lag KRIs?
(A) They are dilatory in nature.
(B) They are predictive in nature.
(C) They are historical in nature.
(D) They represent inherent forward-looking metrics.

Oct/Nov 2024

65. Consider the following summary statements regarding RCSA and inherent risk:
I In general, RCSAs involve self-assessment of a unit's inherent risks and the key control measures mitigating those risks.
II This assessment process leaves the unit with only residual risks, given the current control environment.
III Assessment of inherent risk basically involves computation of operational risk present in a product, process, and human elements involved in banking operation.
IV Potential loss is estimated with the help of historical data on internal and external loss events.
Which of the above statement(s) is/are correct?
(A) Only (I), (II), and (III) are correct
(B) Only (II), (III), and (IV) are correct
(C) Only (I), (III), and (IV) are correct
(D) All statements are correct

May/June 2017

66. The operational management of a bank's customer contact centre tracks specific metrics like "call abandonment rates" and "call waiting times." The primary objective is to evaluate how well the division is achieving its goal of improving customer satisfaction. This application of indicators is best categorized as:
(A) Regulation and Capital Assessments
(B) Constructing Statistical Models
(C) Setting Inherent Risk Likelihood Scales
(D) Monitoring Performance

Oct/Nov 2005

67. Control measures are put in place by banks for specific strategic purposes. Which of the

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basis for prioritizing risks and determining the appropriate level of management attention.

9. (B) Control Product is estimated by adding the design and operating effectiveness scales.
Evaluating control effectiveness involves assessing both the design and the actual operation of controls. The control product is correctly calculated by multiplying the score for control design effectiveness by the score for control operating effectiveness, rather than adding them. This multiplicative approach ensures that both aspects must be strong for the overall control environment to be considered truly effective.

10. (C) Only (I) and (III) are correct
Impact studies within inherent risk assessment involve rating the potential losses associated with products, processes, or business lines. These ratings often use a five-point scale rather than a ten-point scale. The definitions of these impact scales are adaptable to various risk assessment units, allowing organizations to maintain consistent risk measurement standards regardless of the unit's specific size.

11. (D) Risk, Control Effectiveness, and Performance indicators.
Organizations typically utilize three distinct types of indicators for operational risk management: risk indicators, control effectiveness indicators, and performance indicators. Risk indicators track potential exposure, while control effectiveness indicators measure how well mitigation strategies are working. Performance indicators evaluate the achievement of operational targets. Together, these metrics provide a comprehensive view of the organization's risk profile and operational health.

12. (C) Inherent risk
When a manager evaluates a worst-case scenario assuming that all internal controls have failed, they are measuring inherent risk. This represents the raw level of risk exposure associated with an activity or product before any mitigation efforts are considered. Understanding inherent risk is a critical first step in the risk assessment process, as it identifies the fundamental vulnerabilities within operations.

13. (A) Design effectiveness and operational effectiveness
Under the Risk Control Self-Assessment process, the effectiveness of a control system is evaluated based on design effectiveness and operational effectiveness. Design effectiveness determines if the control is theoretically capable of mitigating the risk. Operational effectiveness assesses whether the control is functioning as intended in practice. Both aspects must be evaluated to ensure the overall control environment is robust.

14. (D) Likely — Over 10 times per year
Likelihood scales provide qualitative ratings for the frequency of risk events. While rare and unlikely events occur over longer multi-year periods, the designation of likely typically refers to events occurring multiple times within a single year but not necessarily exceeding ten times. Incorrectly defining these parameters can lead to inaccurate risk assessments and inappropriate resource allocation for mitigation strategies.

15. (A) Only (I), (II), (III), and (IV) are correct
Effective corrective action plans for operational risk mitigation must be specific, measurable, achievable, realistic, and timebound. Actions require senior management owners to ensure completion and must clearly describe control weaknesses. While risk levels in the red zone require mitigation, managers remain responsible for monitoring these actions until the target date for resolution is met and the risk is addressed.

16. (A) It tracks corrective actions continuously, adapts to new controls, and applies at unit and institutional levels.
An effective Risk Control Self-Assessment system is characterized by its dynamic and iterative nature. It involves the continuous tracking of corrective actions and adapts as new controls are implemented or existing ones are modified. This framework is applied consistently at both the business unit and institutional levels, ensuring that risk assessments remain relevant as the internal and external environments evolve.

NODIA

they contribute to the broader risk appetite framework, their focus is often on individual risk types or business units rather than the entire organization.

50. (C) Operations related
Within the framework of illustrative indicators, a rapid increase in the number of loan accounts and frequent revisions in borrower credit ratings are categorized as operations-related risk sources. These metrics monitor the volume and quality of day-to-day business activities. Such trends can signal operational strain or shifting risk profiles within the lending function, requiring management to evaluate if existing controls remain adequate.

51. (D) Systemic monitoring of risks through KRIs completely eliminates the necessity of establishing a risk appetite framework.
Key Risk Indicators are used to track changes in risk exposure and monitor trends over time. When indicators breach pre-assigned thresholds, they signal the need for prompt management action. However, the use of KRIs does not eliminate the necessity for a risk appetite framework. Instead, KRIs function within that framework, providing the data needed to ensure the organization remains within its appetite.

52. (D) Leading KRI
To deploy a measure that acts as a preventive action with predictive power, a bank should implement a leading Key Risk Indicator. These metrics are designed to identify points of emerging risk before unwanted events manifest. By focusing on variables that precede loss events, leading KRIs allow management to take proactive steps to strengthen controls and reduce the likelihood of future operational failures.

53. (C) To establish boundaries that alert the organization to a significant change in risk exposure.
The primary conceptual purpose of setting thresholds or limits for a monitored risk indicator is to establish boundaries for risk management. These limits serve as triggers that alert the organization when there is a significant change in its risk exposure. By receiving these early warnings, management can initiate appropriate responses or escalation procedures to ensure that risks remain within acceptable and manageable levels.

54. (C) Because historical data is often limited and doesn't guarantee future trends will repeat.
Scenario analysis is a vital tool for assessing operational risk because historical data stored in loss databases is often limited in scope. Historical patterns do not guarantee that future trends will repeat in the same manner. By utilizing scenario analysis, organizations can explore potential future events that have not yet occurred, providing a more comprehensive and forward-looking view of their risk environment.

55. (A) The level and types of risk an organisation is willing to assume to achieve its strategic objectives.
Risk appetite is defined as the level and specific types of risk an organization is willing to assume in pursuit of its strategic objectives. This framework guides decision-making by establishing clear boundaries for risk-taking activities. By aligning risk-taking with long-term business goals, the organization ensures that it accepts only those risks that it has the capacity and capability to manage effectively.

56. (A) Historical measures that track past activity and show what has already happened.
Lagging Key Risk Indicators are historical measures that track past activities and provide data on events that have already occurred. These metrics are useful for understanding the effectiveness of past risk management efforts and identifying patterns in operational failures. While they do not provide early warnings like leading indicators, lagging KRIs offer valuable insights for benchmarking and refining future risk assessments.

57. (A) Reverse stress testing
Reverse stress testing involves identifying the point of non-viability, such as a maximum financial loss that would lead to bankruptcy. Analysts then determine which specific risk events, such as catastrophic IT failures or extreme fraud, could trigger such a loss. This methodology focuses on identifying the vulnerabilities that could cause the organization

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identify patterns and systemic failures within operations.

26. (D) Net risk
Residual risk is the level of risk exposure that remains after all management mitigation plans and internal controls have been applied. Within the operational risk framework, this is also commonly referred to as net risk. Calculating net risk is essential for organizations to determine if their current risk levels align with their established risk appetite and if further actions are necessary.

27. (B) High
The color-coded risk management matrix categorizes risk levels by intersecting probability and impact ratings. When a scenario has a service impact rated as critical and a probability of occurrence rated as probable, the final categorized risk level is high. This classification signals that the organization faces a significant exposure that requires immediate attention and potentially more robust control measures to mitigate.

28. (B) P-1, Q-4, R-2, S-3
The rating scale for impact studies maps qualitative descriptors to specific financial loss ranges expressed as a percentage of Minimum Regulatory Capital. Insignificant impacts involve losses less than zero point zero one percent. Minor impacts range from this point up to zero point one percent, while moderate impacts reach up to one percent. Major impacts are defined as losses exceeding one percent.

29. (A) 3 and 4
Under the five-point rating scales, control design classified as semi-automated and preventive is typically assigned a value of three. If operational testing reveals that the control exists but fails regularly, it receives a numeric score of four for operating effectiveness. These specific values are used to calculate the control product, which reflects the overall quality of the mitigation strategy for the risk.

NODIA

30. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
Building accurate likelihood metrics is a complex task that requires consistent data capture and processing. While it is true that workshop facilitators must ensure all participants share common definitions to avoid conflicting interpretations, this requirement for shared understanding is a separate procedural necessity. It does not directly explain why the technical process of capturing regularity for metric construction is fundamentally difficult.

31. (B) Only (I), (II), (III), and (V) are correct
An effective Key Risk Indicator system requires metrics that are relevant, measurable with certainty, and validated by internal audit. Indicators should provide leading, lagging, or current perspectives on risk. However, data for these indicators should be easy and cost-effective to collect. Complex and expensive data collection processes are generally avoided as they can hinder the sustainability and timeliness of monitoring.

32. (A) Only (I) and (II) are correct
Qualitative expressions of risk appetite reinforce that organizations may accept operational risks when the cost of mitigation exceeds expected losses, provided bankruptcy is not a threat. Risks are also accepted when estimated losses fall within prescribed tolerance levels. However, knowingly breaking laws or breaching regulatory requirements is never deemed acceptable behavior, regardless of the potential for short-term profit or business gain.

33. (B) Cases of customer identity misrepresentation.
Performance indicators in operational risk management typically measure efficiency and target achievement, such as IT system outage hours or error rates in transaction processing. Cases of customer identity misrepresentation are categorized as risk exposure indicators rather than performance indicators. This distinction is important because identity misrepresentation reflects an external threat or fraud risk rather than the internal efficiency of business operations.

17. (A) Score 45; Low
To determine the total risk score, the risk product is multiplied by the control product. With a risk product of fifteen and a control product of three, the resulting total risk score is forty-five. According to standard risk profile matrices, a score of forty-five is classified within the low risk zone, indicating that the risk is effectively managed and within appetite.

18. (A) It shows a worst-case scenario where all internal controls put in place have failed to mitigate risk.
Inherent risk is best interpreted as the level of risk exposure that exists when management mitigation plans or controls are absent or completely fail. It represents a worst-case scenario for a specific activity, product, or business line. By establishing this baseline, organizations can better understand the importance of their internal control environment and the potential magnitude of unmitigated failures.

19. (C) P-3, Q-1, R-4, S-2
The scale for Control Operating Effectiveness classifies controls based on their performance history. Highly effective controls are well-controlled with no failures, while effective controls experience only rare failures. Systems that meet requirements might see frequent failures without major losses. Conversely, controls needing improvement are those that exist but fail regularly, indicating a significant weakness in the operational risk environment.

20. (C) Likely
According to the standard five-point likelihood scale used in risk assessment workshops, the frequency of occurrence is categorized based on annual events. An event that has occurred six times over the past year is qualitatively rated as likely. This classification helps management understand that the event is not frequent enough to be constant but occurs often enough to require monitoring.

21. (C) When it tracks an especially important risk or best captures its potential exposure.
A standard piece of data or indicator transitions into a key risk indicator when it is identified as tracking an especially important risk. To be considered key, the metric must effectively capture the potential exposure of the organization to a specific risk event. This designation ensures that management focuses on the most significant variables that impact the firm's risk profile.

22. (A) Only (I) is correct
Implementing a well-designed Risk Control Self-Assessment helps embed operational risk management throughout an organization and improves management attitudes toward risk. While identifying control gaps is beneficial, RCSA itself does not inherently decrease the chance of system failures caused by external events. Instead, it provides the necessary visibility for management to take proactive steps to strengthen the internal control environment.

23. (C) 3 (Moderate)
Severity ratings for operational loss events are determined by comparing net loss ranges to the Minimum Regulatory Capital. A loss event calculated as zero point five percent of the Minimum Regulatory Capital falls within the range typically assigned a severity rating of three. This rating is qualitatively described as moderate, indicating an impact that is significant but not catastrophic for the institution.

24. (D) Minor
The computation of risk zone framework assigns specific categories to business units based on their total risk scores. Standard designations include high, medium, and critical zones, which help prioritize management intervention and capital allocation. Minor is not a recognized category within this specific framework, as the lowest risk levels are typically grouped into a low zone rather than being labeled minor.

25. (C) Only (I), (III), and (IV) are correct
General practice in operational risk management utilizes a five-point scale to rate the likelihood of loss events. Unlikely describes events that may occur in exceptional circumstances, while frequent indicates events expected to happen many times annually. Contrary to some assumptions, the sequence of events is highly important when qualifying risks, as it helps

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based on objective, repeatable data rather than purely subjective or qualitative assessments.

42. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
A true Key Risk Indicator functions as a leading indicator by predicting emerging risks before unwanted events occur. This predictive power exists because leading indicators measure the effectiveness of preventive controls. By monitoring these controls, an organization can gain insight into the likelihood of a given risk event happening in the future, allowing for proactive adjustments to the control environment.

43. (B) They are useful for hard-to-quantify risks and reinforce specific risk culture behaviors.
Qualitative expressions of risk appetite are particularly valuable for managing risks that are difficult to quantify using purely numerical data. These expressions help reinforce desired risk culture behaviors across the organization by providing clear guidance on acceptable and unacceptable conduct. Unlike quantitative metrics that focus on dollar amounts, qualitative statements define the boundaries of professional and ethical behavior for all employees.

44. (D) P-4, Q-2, R-3, S-1
Key Risk Indicators are mapped to specific operational risk sources to identify the root cause of vulnerabilities. System-related risks include unusual durations of downtime, while people-related risks involve conflicting responsibilities. Process-related risks are highlighted by unreconciled entries in accounts. Operations-related risks are indicated by frequent entries in staff deposit accounts, reflecting potential issues in the day-to-day execution of banking activities.

45. (C) Standard stress testing
Evaluating how extreme, large-scale events like a pandemic wave or an economic recession impact an institution's operations constitutes standard stress testing. This process involves analyzing the resilience of the bank's risk factors under hypothetical but plausible adverse conditions. Stress testing allows management to understand potential vulnerabilities and ensure that the organization maintains sufficient capital and operational capacity to withstand severe shocks.

46. (B) Control Effectiveness Indicator.
Tracking the number of network user access rights that have not been reviewed within a specific period serves as a control effectiveness indicator. This metric measures the performance of a specific control activity designed to maintain internal security. By monitoring the completion of these reviews, the organization can assess whether its access management controls are functioning as intended to prevent unauthorized entry.

47. (D) All statements are correct
Scenario analysis and stress testing offer numerous benefits, including testing organizational resilience and providing forward-looking perspectives on future risk events. These techniques complement other identification methods like loss event analysis and RCSA. Furthermore, they encourage creative thinking about future risks among managers and help improve the overall control environment by identifying potential gaps or weaknesses that may not be apparent.

NODIA

48. (B) Metrics requiring a benchmark, such as percentages or ratios, to provide meaningful context.
The comparable characteristic of a good indicator refers to the use of metrics that require a benchmark to provide meaningful context. This often involves using percentages or ratios rather than absolute numbers, allowing for easier comparison across different time periods or business units. Benchmarking ensures that the data is interpreted consistently and accurately reflects changes in the organization's operational risk profile.

49. (A) They tend to be risk-specific and serve as an indication of tolerance rather than overall appetite.
Quantitative expressions of risk appetite are typically risk-specific and provide an indication of the organization's tolerance for specific outcomes. These metrics use mathematical benchmarks and statistical data to set clear boundaries for acceptable risk levels. While

34. (C) Assertion (A) is true, but Reason (R) is false.
Reverse stress testing is a technique used to identify the specific point of non-viability for an organization, such as the maximum withstandable financial loss. However, the events analyzed in reverse stress tests are extreme and rare, occurring much less frequently than standard scenarios. These events are characterized by their devastating impact, which is significantly higher than that of common operational risk scenarios.

35. (D) Assertion (A) is false, but Reason (R) is true.
A repetitive touch trigger does not initiate an immediate alert upon the first boundary breach; instead, it requires the threshold to be reached multiple times. Triggers should be carefully linked to the organization's risk appetite and must consider the resource overhead involved in implementation. Using such triggers helps balance the need for risk monitoring with the practical constraints of management capacity.

36. (D) All statements are correct
When an organization stresses its operational risk exposures, it investigates several critical questions. These include whether controls will remain effective during a crisis and the potential financial and reputational impacts of such events. Additionally, management assesses if these impacts can be mitigated as they occur and whether further controls are necessary to reduce the probability or impact of future stress events.

37. (A) Performance indicators are metrics that measure the achievement of targets but are entirely inapplicable to operational risk reduction.
Performance indicators are essential metrics that measure how well an organization is achieving its operational targets. Contrary to being inapplicable, these indicators are highly relevant to operational risk reduction because failures to meet performance goals often signal underlying operational vulnerabilities. Integrating performance metrics with risk and control indicators provides a holistic view that supports effective risk mitigation and continuous process improvement efforts.

38. (D) Unreasonable transaction–staff ratio
Process-related key risk indicators focus on failures within established procedures, such as unsettled suits, credit rating variations, or screening system failures. An unreasonable transaction-to-staff ratio is categorized as an operations-related indicator rather than a process-related one. This metric specifically monitors the adequacy of staffing levels relative to workload volume, highlighting potential operational strain that could lead to increased error rates.

39. (D) Qualitative risk appetite expressions.
When the Board of Directors issues policies defining specific unacceptable behaviors regardless of financial targets, they are applying qualitative risk appetite expressions. This approach goes beyond numerical metrics to establish a clear risk culture and ethical boundaries. By identifying prohibited activities, such as operating in sanctioned countries, the board sets expectations for the organization's conduct that align with its core values.

40. (C) Both (I) and (II) are correct
The selection of Key Risk Indicators can follow both top-down and bottom-up approaches. In a top-down model, senior management selects the indicators monitored across the entire business to ensure consistency. The bottom-up approach empowers individual business entity managers to choose and monitor indicators most relevant to their specific operational contexts. Both methods contribute to a comprehensive risk monitoring framework.

41. (B) They must be meaningful risk drivers and translatable into verifiable quantitative measures.
To utilize the Advanced Measurement Approach for calculating operational risk capital, banks must use forward-looking measures. These indicator factors are required to be meaningful drivers of risk within the organization. Furthermore, they must be capable of being translated into verifiable quantitative measures. This ensures that the capital calculations are

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to fail, providing a unique perspective on extreme risk exposures.

58. (A) I, II, III, IV
The KRI identification process begins with interviewing business units through Risk Control Self-Assessment. Next, management concentrates on significant risks and their causes, considering both historical and forward-looking indicators. The third step involves determining the specific metric types, such as absolute values or ratios. Finally, data on the chosen indicators is collated on a systematic and consistent basis to ensure meaningful monitoring.

59. (C) Risk tolerance metrics.
When a division establishes specific percentages for acceptable, tolerable, and unacceptable loss trends, it is implementing risk tolerance metrics. These quantitative boundaries provide a clear framework for monitoring operational performance against established limits. By defining these levels based on budgeting and financial capacity, the division ensures that management is alerted whenever loss trends move beyond the predetermined boundaries of the organization's appetite.

60. (A) P-2, Q-3, R-1, S-4
Illustrative Key Risk Indicators are linked to specific operational sources. People-related risks are shown by adverse age profiles of executives. Process-related risks are indicated by high proportions of expired loan documents. System-related risks include frequent violations of security codes. Finally, operations-related risks are reflected in a significant number of unpaid clearing checks, highlighting issues in the execution of daily transaction processing.

61. (C) It vitiates the purpose of ORM if the frequency of their occurrences is correctly captured and comprehensively recorded.
Setting risk thresholds is a fundamental part of operational risk management that triggers different responses based on severity. These thresholds become more effective when they are fixed according to actual risk event experiences. Correctly capturing and comprehensively recording the frequency of risk occurrences does not vitiate the purpose of risk management; instead, it provides the explanation for meaningful threshold setting.

62. (A) Risk Appetite — Metrics based entirely on historical measures.
Risk appetite is a forward-looking concept that defines the level of risk an organization is willing to accept to meet its objectives. It is not based entirely on historical measures. In contrast, residual risk represents exposure after controls, and inherent risk is the risk present without any mitigation. Control risk specifically relates to the probability of material misstatement in financial reporting.

63. (C) Because internal and external loss data is historical and is often incomplete.
Scenario analysis, stress testing, and reverse stress testing are used to supplement loss databases because internal and external loss data is purely historical and often incomplete. These historical records may not capture the full range of potential future events or extreme tail risks. By using these additional testing methodologies, organizations can build more robust statistical models that account for a wider variety of outcomes.

64. (C) They are historical in nature.
Lag Key Risk Indicators are fundamentally historical in nature. They provide information about events and activities that have already taken place within the organization. While they cannot predict future occurrences like leading indicators, they are essential for assessing past performance and the effectiveness of previous risk mitigation strategies. This historical perspective helps management identify long-term trends and areas requiring structural operational improvements.

65. (D) All statements are correct
Risk Control Self-Assessments involve evaluating a unit's inherent risks and the key measures used to mitigate them. This process identifies residual risks that remain within the current control environment. Inherent risk assessment focuses on the operational risk present in products, processes, and human elements. Potential loss is estimated using historical data, providing a foundation for understanding the maximum possible risk exposure.

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P. Board of Directors
Q. Senior Management
R. Information Security Committee
S. Chief Information Security Officer (CISO)

List II: (Responsibilities)

1. Ultimately responsible for information security.
2. Serves as an effective communication channel for management's aims and directs alignment of the security programme.
3. Responsible for establishing an expectation for strong cyber security and providing necessary resources.
4. Responsible for articulating and enforcing policies to protect information assets and reporting to the Head of Risk Management.

(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-3, R-2, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2019

47. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct option:

Assertion (A): Sometimes, even routine antivirus systems cannot protect against any intrusions.

Reason (R): Modern malware aims to avoid signature-based and behavioral detection and may disable anti-virus tools running on the targeted system.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2006

48. Which of the following pairs representing network protection devices and concepts is incorrectly matched?

(A) Firewall — A network security device that monitors and filters incoming and outgoing network traffic.
(B) Grid computing — A security practice that restricts unauthorized applications from executing.
(C) Intrusion Detection Systems — Systems designed to identify unusual activity patterns and potential breaches.
(D) Quarantine — A state of isolation applied to computing assets to prevent the spread of malware or vulnerabilities.

NODIA

May/June 2021

49. Read the following statements concerning emerging technologies and their challenges:

I Virtualization is a modified solution between centralized and decentralized deployments.
II Challenges of virtualization include compatibility, licensing, staff training, and reliability.
III Grid computing networked computers are restricted from using each other's resources.
IV Cloud computing refers to an environment that hosts programs to run everything from e-mail to complex data analysis.
V Security and privacy are the biggest concerns about cloud computing.

Which of the above statement(s) is/are correct?

(A) (I), (II), (IV), and (V)
(B) (I), (II), (III), and (IV)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

Oct/Nov 2010

50. Read the following statements regarding Cloud Computing:

I Cloud computing environments are owned by a company and shared with client companies over the Internet.
II The biggest concerns regarding cloud computing are hardware manufacturing costs.
III At the backend, cloud computing can make use of virtualization and grid computing.

Which of the above statement(s) is/are correct?

(A) (I) and (II)
(B) (I) and (III)
(C) (II) and (III)
(D) (I), (II), and (III)

CHAPTER 20
Technology Risk

May/June 2010

1. Commercial banks are advised to implement an Information Security Management System (ISMS) for their critical processes. Which of the following standards describes the best known ISMS?
(A) ISO/IEC 20000 and ISO/IEC 27031
(B) ISO 9001 and ISO 14001
(C) ISO 31000 and ISO 22301
(D) ISO/IEC 27001 and ISO/IEC 27002

Oct/Nov 2018

2. Which of the following statements about auditing and audit trails is incorrect?
(A) Auditing compares current practices against a set of formulated policies and guidelines.
(B) Audit trails serve as forensic evidence when required and assist in dispute resolution.
(C) Audits should look exclusively into technical aspects and completely ignore the information security governance process.
(D) An audit trail is a step-by-step record by which accounting or other financial data can be traced to their source.

May/June 2023

3. Which technique refers to a scenario where an employee uses programmes to deduct small amounts of money from all customer accounts and adds it to their own account?
(A) Phishing
(B) Vishing
(C) Salami technique
(D) Email-spoofing

Oct/Nov 2007

4. What is the most critical objective of a documented Data Migration Policy in a bank?
(A) To facilitate the immediate physical disposal of outdated computer hardware.
(B) To transition the reporting lines of the IT department directly to the Board of Directors.
(C) To ensure data integrity, completeness, confidentiality, consistency, and continuity during the transition.
(D) To automatically encrypt all employee payroll data using asymmetric cryptography.

May/June 2014

5. Why is proactive Vulnerability Assessment critical for a bank's computer systems?
(A) It ensures that older applications can securely operate on a single piece of hardware through decentralization.
(B) It identifies software flaws early to prevent attackers from exploiting vulnerabilities and gaining system control.
(C) It prevents users from granting administrative access to unauthorized or unverified third-party vendors.
(D) It encrypts data using a private key so that only the corresponding public key can successfully decrypt it.

Oct/Nov 2022

6. When a bank intends to introduce new technologies, what is the most appropriate approach to manage the associated risks?
(A) Implement the technology immediately to gain a competitive advantage and test it live across all production environments.
(B) Authorize deployment only after diligence and testing ensure security issues are addressed or compensating controls are sufficient.
(C) Outsource the entire risk management and security testing process to a certified third-party application service provider for audit.
(D) Avoid all new technologies and digital transformations to maintain the total integrity of the existing legacy infrastructure.

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3. Planning
4. Design

(A) 3, 4, 2, 1
(B) 4, 3, 2, 1
(C) 3, 2, 4, 1
(D) 4, 2, 3, 1

Oct/Nov 2010

22. The 2011 Reserve Bank of India guidelines on Information security, Electronic Banking, Technology risk management, and cyber frauds were based on the report submitted by a working group chaired by:
(A) Shri. B. Mahapatra
(B) Shri. G. Gopalakrishna
(C) Shri. N. Vaghul
(D) Shri. A. K. Purwar

May/June 2007

23. What is the primary function of Application Control in information security?
(A) It provides a detailed step-by-step record by which accounting data can be traced back to the original source.
(B) It monitors unusual network traffic conditions that indicate a sudden surge in system resource utilization.
(C) It manages the systematic and automated deployment of software security patches and system service packs.
(D) It is a practice that blocks or restricts unauthorized applications from executing in ways that put data at risk.

Oct/Nov 2016

24. Virtualization provides benefits such as decentralization and hardware optimization. Which of the following is NOT listed as a challenge of virtualization?
(A) Compatibility and support
(B) Licensing
(C) Staff training
(D) Absolute immunity from malware

May/June 2016

25. Which of the following statements concerning the basic principles of information security is incorrect?
(A) Availability ensures that computing systems remain functional and accessible when needed.
(B) Confidentiality ensures that data cannot be modified without proper authorization.
(C) Authenticity validates that both parties involved in a communication are who they claim they are.
(D) Accountability is established by linking a human to the activities of an online identity through identification.

Oct/Nov 2025

26. Which of the following refers to a computing environment owned by a company that is shared with client companies through web-based services over the Internet to host programs?
(A) Virtualization
(B) Grid computing
(C) Application sandboxing
(D) Cloud computing

May/June 2024

27. What is the primary objective of implementing an Incident Management framework?
(A) To develop the capability to manage incidents so that exposure is contained and recovery is achieved within a specified time.
(B) To evaluate the performance of third-party vendors supplying hardware components and software licenses for the core infrastructure.
(C) To design and deploy standardized user interfaces for all internal and external mobile banking applications.
(D) To ensure that the CIO and CISO share the exact same responsibilities regarding the bank's IT infrastructure and security.

Oct/Nov 2005

28. What is the primary purpose of conducting Penetration Testing in a financial institution?
(A) To uncover the security weaknesses of a system and determine how it can be compromised by a potential attacker.
(B) To compare current practices against a set of policies formulated by the regulator.
(C) To systematically notify, identify, deploy, and verify operating system code revisions.
(D) To track accounting transactions to their source for forensic evidence.

NODIA

(B) It serves as the primary third-party provider responsible for managing all external bank security applications.
(C) It facilitates communication of management goals to ensure security alignment with organizational business objectives.
(D) It replaces the Board of Directors in assuming ultimate responsibility for information security.

May/June 2025

15. Why is user training and awareness considered a vital component of information security?
(A) Because modern anti-malware software cannot function unless manually updated by every end user.
(B) Because it eliminates the need for establishing physical security controls over hardware.
(C) Because users must be capable of writing their own cryptographic algorithms.
(D) Because the human link is acknowledged as the weakest link in the information security chain.

Oct/Nov 2015

16. In the context of information security principles, which term implies that a party to a transaction cannot deny having received or having sent an electronic record?
(A) Non-repudiation
(B) Authenticity
(C) Accountability
(D) Integrity

May/June 2012

17. Critical outcomes of information security governance include all of the following, EXCEPT:
(A) Complete elimination of all operational and market risks within the organization.
(B) Alignment of information security with business strategy to support organizational objectives.
(C) Optimisation of information security investments in support of organizational objectives.
(D) Management and mitigation of risks and reduction of potential impacts on information resources to an acceptable level.

Oct/Nov 2024

18. Which type of encryption involves the use of the same key and algorithm by both the creator and the reader of a file or message?
(A) Symmetric encryption
(B) Asymmetric encryption
(C) Public-Key Cryptography
(D) Grid encryption

May/June 2008

19. Which of the following statements regarding Wireless Security is incorrect?
(A) Wireless data communication devices lack well-defined perimeters, making the implementation of security a challenge.
(B) Unauthorized devices connecting to a wireless network can potentially perform complex man-in-the-middle attacks.
(C) Mitigating wireless risks involves the extensive use of cryptographic encryption to authenticate users and shield communications.
(D) Wireless networks provide higher security than wired networks as they are not constrained by traditional physical connections.

Oct/Nov 2019

20. Which of the following is a correct mandate regarding the provision of electronic delivery channels like internet banking by banks?
(A) Electronic banking channels should be issued only at the option of the customers based on specific written or authenticated electronic requisition.
(B) Banks must issue electronic banking channels to all customers by default upon account opening to promote digital literacy.
(C) Customers opting for electronic delivery channels waive their right to receive clear information about the risks and benefits.
(D) Banks are not required to provide security tokens or sensitize customers about PIN protection if the web application is secure.

May/June 2022

21. Arrange the following stages of an information asset's life cycle in the correct chronological order as considered in information security:
1. Maintenance and disposal
2. Acquisition and implementation

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66. (D) Monitoring Performance
In a customer contact center, tracking metrics such as call abandonment rates and waiting times is primarily used for monitoring performance. These indicators evaluate how well the division is achieving its specific goal of improving customer satisfaction. While these metrics may have implications for operational risk, their immediate and primary application is to assess the efficiency and effectiveness of the center's daily operations.

67. (D) To explicitly punish miscreants.
Banks implement control measures to keep risk within established appetite levels, impose operational discipline, and ensure that corporate targets are achieved. While controls may identify individuals who fail to follow procedures, their primary strategic purpose is not to explicitly punish miscreants. Instead, controls are designed to provide a structured environment that prevents errors and mitigates the impact of potential operational risk events.

68. (A) Only (I) and (II) are correct
Key Risk Indicators are categorized into risk exposure, control effectiveness, and performance indicators. They can function as either lagging or leading indicators. While lagging indicators are historical in nature, leading indicators are considered predictive. It is incorrect to state that lag indicators are predictive, as their primary function is to report on events that have already occurred within the operational environment.

69. (C) Both (I) and (II) are correct
Control risk represents the probability that financial statements will be materially misstated due to failures in a business's internal control environment. Simultaneously, leading Key Risk Indicators serve as measures that are considered predictive in nature, helping organizations identify emerging risks before they result in actual losses. Both concepts are integral to a comprehensive understanding of risk and the effectiveness of mitigation.

70. (B) Key Risk Indicators (KRI)
Escalation triggers are structurally associated with Key Risk Indicators. These triggers define the points at which an indicator's value requires notification to higher levels of management or the board. By linking triggers directly to KRIs, an organization ensures that significant changes in risk exposure are promptly addressed through established escalation procedures, supporting timely decision-making and the maintenance of risk appetite boundaries.

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May/June 2009

29. All defined and documented responsibilities and accountabilities for information security must be communicated to relevant personnel. Which of the following is NOT explicitly mentioned as one of the major defined roles?
(A) Information owner
(B) Application owner
(C) Penetration tester
(D) End user

Oct/Nov 2013

30. Regarding emerging technologies, which statement correctly describes Virtualization?
(A) It allocates an entire physical computer to a single application to maximize hardware efficiency and dedicated usage.
(B) It eliminates the need for software licensing and completely removes compatibility challenges within the infrastructure.
(C) It restricts networked computers from accessing and using the resources of every other computer on the network.
(D) It allows multiple operating systems to reside on single hardware, offering security and stability through decentralization.

May/June 2011

31. Identify the correct pair regarding the deployment of cryptographic techniques.
(A) Symmetric encryption — Uses two mathematically related keys.
(B) Data security — Blocks unauthorized applications from executing.
(C) Asymmetric encryption — Only one key is required to be kept secret (the private key).
(D) Application Control — Protects digital information from unauthorized access throughout its lifecycle.

Oct/Nov 2020

32. Read the following statements regarding the basic principles of Information Security:
I Confidentiality
II Integrity
III Availability
IV Authenticity
V Non-repudiation
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (V)
(B) (I), (II), (IV), and (V)
(C) (I), (III), (IV), and (V)
(D) (I), (II), (III), (IV), and (V)

May/June 2018

33. Match the IT concepts in List I with their characteristics in List II.
List I: (IT Concepts)
P. Symmetric encryption
Q. Asymmetric encryption
R. Cloud Computing
S. Virtualization
List II: (Characteristics)
1. Uses two mathematically related keys, the private key and the public key.
2. Modifies centralized and decentralized deployments by giving each application its own operating system on a single hardware piece.
3. Uses the same key and algorithm by the creator and reader of a file.
4. Hosts programs to run everything from e-mail to data analysis over the Internet through web-based services.
(A) P-2, Q-3, R-1, S-4
(B) P-3, Q-1, R-4, S-2
(C) P-3, Q-1, R-2, S-4
(D) P-1, Q-4, R-2, S-3

Oct/Nov 2021

34. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct option:
Assertion (A): Wireless network security is relatively simple and immune to man-in-the-middle attacks.
Reason (R): Wireless data communication devices do not have well-defined perimeters or well-defined access points.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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May/June 2005

7. What is defined as any potential for technology failures to disrupt a business, such as information security incidents or service outages?
(A) Information Security Risk
(B) Technology Risk
(C) Operational Risk
(D) Cyber Risk

Oct/Nov 2011

8. Which statement is correct regarding Patch Management?
(A) It is solely the responsibility of bank end-users to apply security patches to the core banking system manually.
(B) It uses a documented standard to address system vulnerabilities quickly and effectively to minimize potential business impact.
(C) It is functionally synonymous with penetration testing and involves actively exploiting system vulnerabilities to test resilience.
(D) It requires maintaining an entire computer for one application to prevent malicious malware from spreading.

May/June 2021

9. Which of the following is NOT recognized as one of the important network protection devices forming part of a "defense in depth" strategy?
(A) Firewalls
(B) Application sandboxes
(C) Intrusion Detection Systems
(D) Network Intrusion Prevention Systems

Oct/Nov 2009

10. How does a security assessment primarily differ from a security audit?
(A) An assessment is conducted by external regulators, whereas an audit is conducted by internal staff.
(B) An assessment tests the physical security of a bank, while an audit focuses solely on cyber threats.
(C) An assessment does not have a set of policies or standards to test against, unlike an audit.
(D) An assessment requires bypassing security controls maliciously, whereas an audit observes them passively.

May/June 2017

11. To ensure human accountability in an online system, several security principles must be established in sequence. Arrange the following processes in the correct logical and procedural sequence:
1. Authorization
2. Accountability
3. Identification
4. Authentication

(A) 3, 4, 1, 2
(B) 4, 3, 2, 1
(C) 1, 2, 3, 4
(D) 3, 1, 4, 2

Oct/Nov 2014

12. To whom should the Chief Information Security Officer (CISO) directly report to ensure effective security management across the bank?
(A) Chief Information Officer (CIO)
(B) Chief Executive Officer (CEO)
(C) Head of Risk Management
(D) Board of Directors

May/June 2019

13. Identify the incorrect statement regarding the organizational structure, roles, and responsibilities for Information Security.
(A) The CISO must have a direct reporting relationship with the CIO to ensure seamless integration of security into IT.
(B) The Board of Directors is ultimately responsible for information security within the bank.
(C) The information security function should focus exclusively on information security management and be segregated from the IT division.
(D) Training board members about technological developments is a vital risk management tool.

Oct/Nov 2006

14. Which of the following statements accurately describes the role of the Information Security Committee?
(A) It is exclusively responsible for the daily implementation of IT systems and computer hardware.

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(C) MSP — Managed Service Provider
(D) BSP — Broadband Security Provider

May/June 2013

41. Read the following scenario to answer the question:
A bank reinstates the CISO as a separate entity and forms a new group where the CISO serves as the member secretary to align the security programme with organizational objectives. This group is known as the:
(A) Technology Evaluation Committee
(B) Information Security Committee
(C) Incident Management Team
(D) Malware Response Group

Oct/Nov 2023

42. Match the critical components of information security in List I with their implementation objectives in List II.
List I: (Security Components)
P. Inventory and information classification
Q. Access Control
R. Change Management
S. Patch Management
List II: (Objectives)
1. Authorizes usage of information assets only where a valid business need exists and for a specific time.
2. Addresses technical system and software vulnerabilities quickly to reduce business impact.
3. Assigns levels of sensitivity and criticality to determine the level of protection for each asset.
4. Covers upgrades and modifications to application, software, and business information.

(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2023

43. Read the following statements regarding Information Security and Critical Service Providers/Vendors:
I Banks use third-party service providers in capacities like ISP, ASP, MSP, or BPO.
II Management should evaluate the role that the third party performs in relation to the IT environment.
III Due diligence of technology-related service providers is critical as they can jeopardize the whole security system.
IV Third-party vendors should be fully trained to safeguard the bank's security.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), (III), and (IV)

Oct/Nov 2018

44. Read the following statements regarding Personnel Security:
I Authorized users with intimate knowledge of internal processes pose a potential threat to systems and data.
II Risk exposures from internal users include holding data hostage and stealing strategic data for espionage.
III Background and credit checks are unnecessary for new employees if the bank has a robust physical security perimeter.
Which of the above statement(s) is/are correct?
(A) (I) and (II)
(B) (II) and (III)
(C) (I) and (III)
(D) (I), (II), and (III)

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May/June 2012

45. Read the following scenario to answer the question:
An internal audit at a mid-sized bank revealed that an automated program had been slightly altering the rounding off of interest credited to millions of customer accounts over the past year. The fractional amounts deducted were transferred to a dummy account operated by an insider. The specific method used by the insider to deduct small amounts of money is formally referred to as:
(A) Social Engineering
(B) Distributed Denial of Service
(C) Salami technique
(D) Phishing

Oct/Nov 2014

46. Match the organizational roles in List I with their corresponding responsibilities in List II.
List I: (Organizational Roles)

May/June 2020

35. Read the following statements regarding DDoS/DoS attacks:

I A sudden surge in system resource utilization and unusual network traffic could be an indication of a DDoS attack.

II Preventing DDoS attacks is completely unrelated to the principle of "Availability" in information security.

Which of the above statement(s) is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2012

36. Read the following scenario to answer the question:

An internal audit at a mid-sized bank revealed that an automated program had been slightly altering the rounding off of interest credited to millions of customer accounts over the past year. The fractional amounts deducted were transferred to a dummy account operated by an insider. To prevent such fraud, which control measure enforces permissions necessary only for specific job functions?

(A) Access Control with a valid business need
(B) Penetration Testing
(C) Environmental controls
(D) Horizontal scaling

May/June 2006

37. Match the Basic Principles of Information Security in List I with their correct descriptions in List II.

List I: (Basic Principles)

P. Confidentiality
Q. Integrity
R. Availability
S. Authenticity

List II: (Descriptions)

1. Ensures that data, transactions, or communications are genuine.
2. Prevents the disclosure of information to unauthorized individuals or systems.
3. Aims to keep computing systems and communication channels functioning correctly at all times.
4. Ensures that data cannot be modified without authorization.

(A) P-2, Q-4, R-3, S-1
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2017

38. Read the following statements regarding a comprehensive security programme:

I Development and ongoing maintenance of security policies.

II Ensuring security is integral to all organizational processes.

III Generation of meaningful metrics of security performance.

IV Classification and assignment of ownership of information assets.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), (III), and (IV)

May/June 2015

39. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct option:

Assertion (A): The Chief Information Security Officer (CISO) should not have a direct reporting relationship with the Chief Information Officer (CIO).

Reason (R): There must be a segregation of duties between the security officer dealing with information systems security and the IT division which actually implements the computer systems.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2008

40. Which of the following pairs regarding Service Providers is incorrectly matched?

(A) ISP — Internet Service Provider
(B) ASP — Application Service Provider

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May/June 2005

51. Read the following scenario to answer the question:
A leading commercial bank is restructuring its IT and Security departments. The board decides to merge the roles of the Chief Information Officer (CIO) and the Chief Information Security Officer (CISO) into one position. Based on Information Security Governance guidelines, what is the major risk in this structure?
(A) It fails to provide the board with regular audit trails for monitoring organizational performance.
(B) It prevents the bank from adopting virtualization and cloud computing technologies for growth.
(C) It restricts the bank from implementing symmetric encryption in their various delivery channels.
(D) It violates the segregation of duties between IT system implementation and information systems security.

Oct/Nov 2022

52. Which of the following pairs concerning information security terms is correctly matched?
(A) Malware — Validates that both parties in a transaction are who they claim they are for security.
(B) Non-repudiation — Modifying sensitive data files accidentally or with malicious intent by a user.
(C) Phishing — Ensuring high availability of computing systems during unexpected power outages.
(D) Salami technique — Deducting small amounts of money from all customer accounts to add to an employee's own account.

May/June 2018

53. Read the following statements regarding Malware:
I Modern malware aims to avoid signature-based and behavioral detection and may disable anti-virus tools running on the targeted system.
II Anti-malware tools attempt to detect malware and block their execution, eliminating the need for staff training on opening external attachments.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2016

54. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct option:
Assertion (A): Asymmetric encryption lessens the risk of key exposure.
Reason (R): When one key is used to encrypt, only the other key can decrypt, requiring only the private key to be kept secret.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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May/June 2014

55. Read the following statements regarding the responsibilities of the Information Security Committee:
I Developing and facilitating the implementation of IS policies and standards.
II Approving and monitoring major information security projects and budgets.
III Directing the day-to-day coding of the bank's core banking software.
IV Reviewing the status of security awareness programmes.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

Oct/Nov 2007

56. Match the Information Security Assurance techniques in List I with their definitions in List II.

List I: (Assurance Techniques)
P. Penetration Testing
Q. Audits
R. Assessment
S. Vulnerability Assessment
List II: (Definitions)
1. Scanning computer systems to address discovered flaws proactively before attackers gain control.
2. A formalized set of procedures designed to bypass security controls to test a system's resistance.
3. Compares current practices against a set of formulated policies, standards, or guidelines.
4. A study to locate security vulnerabilities that differs by not having a set of standards to test against.

(A) P-2, Q-3, R-4, S-1
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2025

57. Read the following scenario to answer the question:
An internal audit at a mid-sized bank revealed that an automated program had been slightly altering the rounding off of interest credited to millions of customer accounts over the past year. The fractional amounts deducted were transferred to a dummy account operated by an insider. Which principle of information security has been primarily violated in this scenario?
(A) Integrity
(B) Confidentiality
(C) Availability
(D) Non-repudiation

Oct/Nov 2019

58. Read the following statements regarding Information Asset Classification:
I A detailed inventory of information assets is the final step in an information security audit.
II By assigning classes or levels of sensitivity to information resources, it becomes possible to define appropriate access controls.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2009

59. Read the following statements regarding critical outcomes of Information Security Governance:
I Alignment of information security with business strategy.
II Management and mitigation of risks to an acceptable level.
III Management of performance of information security by measuring metrics.
IV Optimisation of information security investments.
V Complete outsourcing of all security components to third-party vendors.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (IV)
(B) (I), (II), (IV), and (V)
(C) (I), (III), (IV), and (V)
(D) (II), (III), (IV), and (V)

Oct/Nov 2011

60. Read the following statements regarding the provision of Electronic Delivery Channels:
I Electronic banking channels should be issued based on specific written or authenticated electronic requisition from the customer.
II Customers should be forced to opt for internet banking to reduce the bank's operational costs.
III Banks must sensitize customers on the need to protect their PINs and security tokens.
Which of the above statement(s) is/are correct?
(A) (I) and (II)
(B) (II) and (III)
(C) (I) and (III)
(D) (I), (II), and (III)

May/June 2010

61. Read the following scenario to answer the question:
A bank starts using an external web-based service over the Internet for complex data

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analysis, sharing the environment with other client companies. In this Cloud Computing setup, what should be the bank's biggest concern?

(A) The physical location of the bank's internal firewalls.
(B) The speed of the bank's local intranet.
(C) Security and privacy of the data hosted on the cloud.
(D) The frequency of mandatory staff physical training.

Oct/Nov 2024

62. Read the following scenario to answer the question:
During a system upgrade, a bank partners with a third-party Managed Service Provider (MSP) to handle the database transition. What is the most critical action the bank's management must undertake regarding this vendor?

(A) Conduct due diligence of the technology-related service provider and evaluate their role in relation to the IT environment.
(B) Force the external vendor to adopt the bank's internal human resource and salary structure policies for its staff.
(C) Outsource the internal Information Security Committee's oversight functions to the MSP for better management.
(D) Provide the MSP with symmetric keys for unrestricted and permanent access to all existing bank data archives.

May/June 2017

63. Read the following scenario to answer the question:
In a bank, an Information Security Committee aims to document an expectation for strong cyber security. Who must take the lead in implementing the Board-approved information security policy and establishing necessary organizational processes?

(A) End users
(B) Third-party service providers
(C) Senior Management
(D) Application owners

Oct/Nov 2005

64. Read the following scenario to answer the question:
Regulators conduct an evaluation of a bank's security landscape. This study focuses on locating security vulnerabilities and identifying corrective actions without testing against a strict set of formulated policies. This type of evaluation is defined as an:

(A) Audit
(B) Application Control check
(C) Assessment
(D) Access Control review

May/June 2020

65. Read the following scenario to answer the question:
To reduce costs, a bank's data center stops allocating an entire physical computer for a single application. Instead, each application is given its own operating system on a single piece of hardware. This approach is referred to as:

(A) Grid Computing
(B) Virtualization
(C) Patch Management
(D) Salami Technique

Oct/Nov 2015

66. Read the following scenario to answer the question:
A cooperative bank is upgrading its legacy core banking system to a modern web-based platform. During this transition, vast amounts of customer and financial data must be moved. Which specific documented policy must the bank put in place to ensure data integrity during this activity?

(A) Network Security Policy
(B) Wireless Security Policy
(C) Patch Management Policy
(D) Migration Policy

May/June 2013

67. Read the following scenario to answer the question:
After a security breach, a CISO mandates a formalized set of procedures designed to actively bypass security controls to uncover weaknesses. This proactive measure is known as:

(A) Vulnerability Assessment
(B) Audit Trail tracking
(C) Incident Management
(D) Penetration Testing

Oct/Nov 2021

68. Read the following scenario to answer the question:

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server density, but it also introduces specific operational challenges. These include issues related to software licensing, the need for specialized staff training, and compatibility with legacy systems. Importantly, virtualization does not provide absolute immunity from malware; virtual environments remain susceptible to various cyber threats if not properly secured.

25. (B) Confidentiality ensures that data cannot be modified without proper authorization.
The principle that ensures data cannot be modified without proper authorization is actually called integrity. Confidentiality, on the other hand, focuses on preventing the disclosure of sensitive information to unauthorized individuals or systems. Both are core components of the CIA triad, which serves as the foundation for protecting information assets from various security threats and vulnerabilities.

26. (D) Cloud computing
Cloud computing refers to an environment where a provider owns and manages infrastructure, offering services over the internet to multiple clients. This setup allows companies to host programs for various functions, ranging from email to complex data analysis, without maintaining physical servers. While providing flexibility and scalability, it requires stringent security and privacy measures to protect shared data environments.

27. (A) To develop the capability to manage incidents so that exposure is contained and recovery is achieved within a specified time.
Incident management frameworks are designed to help organizations respond effectively to security breaches or technical failures. The primary objective is to contain the exposure caused by an incident and restore normal services within a predefined timeframe. By establishing clear procedures and response teams, banks can minimize the business impact and financial losses resulting from unexpected security events.

28. (A) To uncover the security weaknesses of a system and determine how it can be compromised by a potential attacker.
Penetration testing is a proactive security measure that involves simulating cyberattacks against an organization's systems. Its primary purpose is to identify security weaknesses and determine the extent to which a system can be compromised. This process helps banks understand their vulnerabilities from an attacker's perspective, allowing them to strengthen their defenses and remediate discovered flaws effectively.

29. (C) Penetration tester
Organizations define specific roles and responsibilities to ensure accountability for information security. Common roles include information owners, application owners, and end users, each with distinct duties for protecting assets. While a penetration tester performs a vital technical function, it is not typically listed as a primary, permanent organizational role within the general information security responsibility framework.

30. (D) It allows multiple operating systems to reside on single hardware, offering security and stability through decentralization.
Virtualization is a technology that allows multiple virtual machines, each with its own operating system, to run concurrently on a single piece of physical hardware. This approach modifies centralized and decentralized deployments by giving each application an isolated environment. It offers benefits like hardware optimization and improved stability while presenting challenges such as compatibility and specialized staff training.

31. (C) Asymmetric encryption — Only one key is required to be kept secret (the private key).
Asymmetric encryption, also known as public-key cryptography, uses a pair of mathematically related keys. In this system, the public key can be shared openly with anyone, while the private key must be kept secret by the owner. This mechanism significantly lessens the risk of key exposure because the secret private key never needs to be shared or transmitted.

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ANSWERS

1. (D) ISO/IEC 27001 and ISO/IEC 27002
The Information Security Management System provides a systematic approach for managing sensitive company information so that it remains secure. International standards such as ISO/IEC 27001 and ISO/IEC 27002 are widely recognized for establishing, implementing, and maintaining these frameworks. They help organizations protect information assets by addressing people, processes, and technology through risk management.

2. (C) Audits should look exclusively into technical aspects and completely ignore the information security governance process.
Information security audits are comprehensive evaluations that compare current organizational practices against established policies and guidelines. These audits must encompass more than just technical settings; they are required to include the information security governance process to ensure overall compliance. Omitting governance would leave significant gaps in the assessment of the security framework.

3. (C) Salami technique
The salami technique involves a series of small, nearly imperceptible fraudulent acts that together result in a significant theft. In banking environments, this often manifests as an employee using specialized software to skim minute amounts of money from numerous customer accounts. Because the individual amounts are negligible, the fraud frequently goes undetected by standard manual monitoring.

4. (C) To ensure data integrity, completeness, confidentiality, consistency, and continuity during the transition.
A documented Data Migration Policy is essential when transferring data between systems to prevent loss or corruption. Its primary goal is maintaining the highest levels of data integrity and confidentiality throughout the migration process. This ensures that information remains complete and consistent, supporting business continuity while protecting sensitive financial records from unauthorized access or errors.

5. (B) It identifies software flaws early to prevent attackers from exploiting vulnerabilities and gaining system control.
Proactive vulnerability assessments involve systematic scanning and analysis of computer systems to discover security weaknesses. By identifying these software flaws early, banks can apply necessary security measures before malicious actors have the opportunity to exploit them. This preventive approach is critical for maintaining robust defense systems and preventing unauthorized individuals from gaining control over banking infrastructure.

6. (B) Authorize deployment only after diligence and testing ensure security issues are addressed or compensating controls are sufficient.
Managing risks associated with new technologies requires a balanced approach of due diligence and rigorous testing before live implementation. Organizations must ensure that any discovered security issues are fully addressed or mitigated through appropriate compensating controls. This structured authorization process prevents the introduction of unknown vulnerabilities into the production environment, maintaining the overall stability of banking systems.

7. (B) Technology Risk
Technology risk encompasses any potential for business disruption resulting from the failure or inadequacy of technical systems. This includes diverse events such as information security breaches, software malfunctions, and unexpected service outages. Managing this risk is essential for modern banks, as their operations depend heavily on the availability and reliability of complex information technology infrastructures.

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40. (D) BSP — Broadband Security Provider
In the context of banking and IT, common service providers include ISPs for internet, ASPs for applications, and MSPs for managed services. The term "BSP" is not a standard industry acronym for "Broadband Security Provider" in this specific framework. Understanding the correct terminology for third-party vendors is essential for managing service-level agreements and establishing robust information security protocols.

41. (B) Information Security Committee
An Information Security Committee is a governance body established to align a bank's security program with its organizational business objectives. This committee typically includes the CISO as a member secretary and serves as a vital communication channel for management's security goals. Its role is to oversee major projects, monitor budgets, and ensure that information security remains an organizational priority.

42. (C) P-3, Q-1, R-4, S-2
Security components are implemented with specific objectives to protect information assets. Inventory classification determines the protection level based on sensitivity. Access control ensures usage is based on business needs. Change management covers software upgrades, while patch management quickly addresses system vulnerabilities. Mapping these components to their correct objectives is vital for maintaining a secure and resilient banking infrastructure.

43. (D) (I), (II), (III), and (IV)
Banks rely heavily on various third-party service providers like ISPs and MSPs for critical operations. Management must perform thorough due diligence and evaluate the specific roles these vendors play within the IT environment. Because technology-related providers can influence the entire security system, it is essential that they are fully integrated into the bank's security training and compliance frameworks.

44. (A) (I) and (II)
Personnel security focuses on managing risks posed by internal users who have intimate knowledge of bank processes. These authorized individuals can potentially steal strategic data or hold systems hostage. While robust physical perimeters are helpful, they do not eliminate the need for thorough background and credit checks. Such checks are necessary to identify potential internal threats before employees gain access.

45. (C) Salami technique
The method where an individual deducts very small amounts of money from many accounts and transfers them to a controlled account is known as the salami technique. It is a form of financial fraud that relies on the cumulative effect of many tiny thefts, which often go unnoticed by individual account holders. This technique exploits automated processing systems to skim fractional interest amounts.

46. (B) P-1, Q-3, R-2, S-4
Organizational roles in information security carry specific responsibilities. The Board is ultimately responsible, while Senior Management establishes cyber security expectations and resources. The Information Security Committee facilitates communication of goals, and the CISO articulates and enforces policies. Correctly identifying these roles is essential for creating a structured governance framework that ensures accountability across all levels of the bank.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Antivirus systems may sometimes fail to detect intrusions because modern malware is designed to evade traditional signature-based and behavioral detection methods. Malicious code often attempts to actively disable security tools on a targeted system to remain hidden. Therefore, the assertion that routine antivirus systems have limitations is true, and the reasoning regarding malware's sophisticated evasion techniques provides the correct explanation.

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16. (A) Non-repudiation
Non-repudiation is a fundamental security principle ensuring that a party in a digital transaction cannot later deny their involvement. It provides legal and technical evidence of the origin and receipt of electronic records. This is typically achieved through digital signatures and audit logs, which link a specific user to an action, making it impossible to disclaim the communication.

17. (A) Complete elimination of all operational and market risks within the organization.
Information security governance aims to align security with business strategy and optimize investments. While it focuses on managing and mitigating risks to an acceptable level, complete elimination of all operational or market risks is impossible in any business environment. Effective governance balances security costs with the need to protect information resources and maintain overall organizational resilience against threats.

18. (A) Symmetric encryption
Symmetric encryption uses a single shared secret key for both the encryption of plaintext and the decryption of ciphertext. Both the sender and the receiver must possess this identical key and use the same mathematical algorithm to access the information. While efficient for processing large volumes of data, it requires a secure method for exchanging the secret key beforehand.

19. (D) Wireless networks provide higher security than wired networks as they are not constrained by traditional physical connections.
Wireless networks present unique security challenges because they lack well-defined physical perimeters, allowing signals to be intercepted from outside a building. This lack of physical constraint makes them inherently less secure than traditional wired networks. Mitigation requires strong cryptographic encryption and robust authentication methods to prevent unauthorized access and protect communications from potential man-in-the-middle attacks.

20. (A) Electronic banking channels should be issued only at the option of the customers based on specific written or authenticated electronic requisition.
Regulatory guidelines state that electronic banking services must be provided based on explicit customer consent rather than by default. Banks are required to obtain a specific written or authenticated electronic request before issuing such delivery channels. Additionally, they must provide clear information about the risks involved and educate customers on protecting their credentials and security tokens.

21. (A) 3, 4, 2, 1
The life cycle of an information asset begins with a planning stage to determine requirements. This is followed by design, where the architecture is specified. The third stage is acquisition and implementation, where the asset is obtained and deployed. Finally, maintenance and disposal cover the operational phase and the secure removal of the asset once it is retired.

22. (B) Shri. G. Gopalakrishna
In 2011, the Reserve Bank of India issued comprehensive guidelines focusing on information security, electronic banking, and technology risk management. These guidelines were formulated based on the detailed recommendations of a working group. This influential group was chaired by Shri. G. Gopalakrishna, and its report laid the foundation for modern cybersecurity standards in the Indian banking sector.

23. (D) It is a practice that blocks or restricts unauthorized applications from executing in ways that put data at risk.
Application control is a security practice designed to manage which software programs are permitted to execute on a system. Its primary purpose is to block unauthorized or malicious applications from running, thereby protecting data from various threats. This control mechanism ensures that only approved software interacts with the banking environment, significantly reducing the risk of malware infections.

24. (D) Absolute immunity from malware
Virtualization offers significant benefits like hardware optimization and improved

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During a virtualization implementation, the IT department encounters issues where legacy applications fail to run smoothly in the newly created application sandboxes. This issue primarily relates to:
(A) Compatibility and support
(B) Remote Access configuration
(C) Penetration testing failures
(D) Asymmetric key generation

May/June 2024

69. Read the following scenario to answer the question:
A new web-based platform requires multiple layers of defenses, a strategy known as "defense in depth". To monitor and filter incoming and outgoing traffic based on security rules, which network protection device should the bank primarily install?
(A) Virtual Machine
(B) Firewall
(C) Grid network
(D) Audit Trail generator

NODIA

Oct/Nov 2008

70. Read the following scenario to answer the question:
To prevent delays in fixing software flaws, a bank institutes a systematic process for the notification, identification, deployment, and verification of software code revisions. This process is formally referred to as:
(A) Change Management
(B) Patch Management
(C) Encryption key management
(D) Audit Trail management

32. (D) (I), (II), (III), (IV), and (V)
The basic principles of information security form a comprehensive framework for protecting data. These include confidentiality, integrity, availability, authenticity, and non-repudiation. Each principle addresses a specific aspect of security, such as preventing unauthorized disclosure, ensuring data accuracy, maintaining system uptime, verifying identities, and preventing the denial of digital actions. Together, they ensure a robust and reliable computing environment.

33. (B) P-3, Q-1, R-4, S-2
Information technology encompasses various concepts with distinct characteristics. Symmetric encryption uses identical keys for creators and readers, while asymmetric encryption uses public and private key pairs. Cloud computing hosts internet-based programs shared across companies. Virtualization optimizes hardware by allowing multiple operating systems on one machine. Understanding these distinctions is fundamental for implementing effective and secure organizational technology infrastructures.

34. (D) Assertion (A) is false, but Reason (R) is true.
Wireless network security is complex and highly susceptible to man-in-the-middle attacks, making the assertion false. This vulnerability exists because wireless signals lack well-defined physical perimeters, allowing interceptors to access communication channels without physical connection. Therefore, while the assertion about simplicity and immunity is incorrect, the reasoning regarding the lack of defined perimeters is factually accurate.

35. (A) Only (I)
Distributed Denial of Service attacks aim to overwhelm systems, making them unavailable to legitimate users. A sudden increase in system resource utilization and abnormal network traffic patterns are classic indicators of such an attack. Contrary to the second statement, preventing these attacks is directly related to the principle of "Availability," as their primary purpose is to disrupt service accessibility.

36. (A) Access Control with a valid business need
Access control is a fundamental security measure that restricts system permissions based on specific job functions. By ensuring that employees only have access to data and tools necessary for their roles, banks can prevent unauthorized activities. In cases like internal fraud involving interest rounding, robust access controls based on a valid business need help minimize opportunities for insider exploitation.

37. (A) P-2, Q-4, R-3, S-1
The core principles of information security have distinct roles in protecting organizational assets. Confidentiality prevents unauthorized disclosure, while integrity ensures that data remains unmodified by unauthorized parties. Availability focuses on keeping systems and channels operational for users. Authenticity validates that communications and transactions are genuine. Correctly mapping these principles is essential for designing a comprehensive and effective security strategy.

38. (D) (I), (II), (III), and (IV)
A comprehensive security program must integrate multiple organizational facets. This involves the ongoing maintenance of security policies and ensuring that security is a core component of all business processes. Additionally, generating performance metrics and classifying information assets by ownership are crucial. All these elements work together to provide a robust framework that protects the bank's information resources effectively.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
To maintain effective oversight, the Chief Information Security Officer should not report directly to the Chief Information Officer. This separation is necessary because the IT division implements the systems, while the CISO monitors their security. Segregating these duties ensures that security assessments remain objective and that there is no conflict of interest between operational speed and security requirements.

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8. (B) It uses a documented standard to address system vulnerabilities quickly and effectively to minimize potential business impact.
Patch management is a critical administrative process involving the acquisition, testing, and installation of software updates. It utilizes documented standards to ensure that vulnerabilities within operating systems and applications are remediated promptly. This systematic approach reduces the window of opportunity for attackers to exploit known flaws, thereby minimizing the potential impact on banking business operations.

9. (B) Application sandboxes
Defense in depth strategies utilize multiple layers of security to protect organizational networks. Common network protection devices include firewalls, intrusion detection systems, and network intrusion prevention systems. While application sandboxing provides an isolated environment for running suspicious code, it is typically categorized differently from core network perimeter protection tools like firewalls and network-wide intrusion detection platforms.

10. (C) An assessment does not have a set of policies or standards to test against, unlike an audit.
Security assessments and audits differ primarily in their reference frameworks. An audit is a formal examination that compares practices against a specific set of formulated policies, standards, or regulatory guidelines. In contrast, an assessment is a more flexible study designed to identify vulnerabilities and suggest corrective actions without necessarily measuring against a predefined set of internal rules.

11. (A) 3, 4, 1, 2
Establishing human accountability in online systems follows a logical four-step sequence. First, a user provides their identification to claim an identity. Next, authentication verifies this claim through passwords or biometrics. Once verified, authorization determines the specific actions the user is permitted to perform. Finally, accountability is established by logging and monitoring these activities to track actions.

12. (C) Head of Risk Management
To ensure independence and a comprehensive view of organizational security, the Chief Information Security Officer generally reports to the Head of Risk Management. This reporting structure separates security oversight from the technical implementation duties typically handled by the IT department. It allows the CISO to align security strategies with the bank's broader risk management framework and objectives.

13. (A) The CISO must have a direct reporting relationship with the CIO to ensure seamless integration of security into IT.
Effective information security management requires a clear segregation of duties between those who implement IT systems and those who oversee security. A direct reporting relationship between the CISO and the CIO is often discouraged to avoid conflicts of interest. Instead, the CISO should report to a risk management head to maintain objectivity and ensure independent security oversight.

14. (C) It facilitates communication of management goals to ensure security alignment with organizational business objectives.
An Information Security Committee plays a vital role in governance by bridging the gap between senior management and technical security teams. It facilitates the communication of high-level goals and ensures that the security program aligns with the organization's business objectives. This committee monitors major projects and budgets, providing oversight to ensure information assets are adequately protected.

15. (D) Because the human link is acknowledged as the weakest link in the information security chain.
Human error and manipulation remain significant vulnerabilities in any security framework. Even the most advanced technical controls can be bypassed if users are unaware of risks such as social engineering or phishing. Consequently, training and awareness are essential to strengthen the human link, which is widely acknowledged as the weakest part of the information security chain.

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48. (B) Grid computing — A security practice that restricts unauthorized applications from executing.
Grid computing refers to networking computers so they can share resources, not a security practice for restricting applications. The practice of blocking unauthorized software from running is correctly termed "Application Control." Other terms like firewalls, intrusion detection systems, and quarantine are correctly matched with their security functions. Identifying these correct definitions is important for maintaining an accurate understanding of network security components.

49. (A) (I), (II), (IV), and (V)
Emerging technologies like virtualization and cloud computing offer operational benefits but bring significant security and privacy concerns. Challenges include licensing, compatibility, and the need for specialized training. While cloud computing hosts internet-based programs, grid computing actually encourages resource sharing rather than restricting it. Therefore, statements regarding the benefits and challenges are correct, while the description of grid computing restrictions is inaccurate.

50. (B) (I) and (III)
Cloud computing involves sharing a provider's infrastructure with multiple client companies over the internet. At the backend, these environments often utilize virtualization and grid computing to optimize resource delivery. While security and privacy are paramount concerns, hardware manufacturing costs are typically a primary concern for the provider, not the banking customer using the cloud services.

51. (D) It violates the segregation of duties between IT system implementation and information systems security.
Merging the roles of the CIO and the CISO creates a significant risk by violating the principle of segregation of duties. The CIO is responsible for implementing and operating IT systems, while the CISO must independently monitor and secure those same systems. Combining these functions leads to a conflict of interest, as security oversight could be compromised by operational or budgetary priorities.

52. (D) Salami technique — Deducting small amounts of money from all customer accounts to add to an employee's own account.
The salami technique is correctly defined as a fraudulent practice involving the deduction of minute sums from numerous accounts for personal gain. Other terms like malware, non-repudiation, and phishing are often confused but refer to malicious software, the inability to deny a transaction, and deceptive attempts to gain sensitive information, respectively. Understanding these definitions is key to identifying specific security threats.

53. (A) Only (I)
Modern malware is increasingly sophisticated, designed to bypass signature-based detection and even disable security software. While anti-malware tools are essential for defense, they do not eliminate the need for user training. Staff must still be educated on risks like opening suspicious attachments, as technical controls alone cannot protect against all human-targeted attacks. Thus, only the first statement regarding malware behavior is correct.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Asymmetric encryption significantly reduces the risk of key exposure because it uses a public key for encryption and a private key for decryption. Since only the private key must be kept secret and never needs to be shared, the chance of compromising the secret key during transmission is eliminated. This makes the assertion true and the reasoning its correct explanation.

55. (B) (I), (II), and (IV)
The Information Security Committee is responsible for high-level governance tasks such as developing policies, monitoring major security projects, and reviewing awareness programs. However, directing the day-to-day coding of software is a technical operational task belonging to the IT development team, not a committee function. Therefore, the committee's role focuses on strategic oversight and policy

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implementation rather than technical software engineering.

56. (A) P-2, Q-3, R-4, S-1
Security assurance techniques serve different purposes. Penetration testing involves formal procedures to bypass controls. Audits compare practices against specific policies. Assessments locate vulnerabilities without a set of standards. Vulnerability assessments proactively scan systems for flaws. Correctly matching these techniques to their definitions is essential for understanding how organizations verify and maintain their information security posture.

57. (A) Integrity
Integrity ensures that data and financial records are accurate and have not been modified without proper authorization. In a scenario where an automated program alters interest calculations to divert funds, the accuracy and trustworthiness of the financial data are compromised. This unauthorized modification of records is a direct violation of the integrity principle, which is fundamental to banking security.

58. (B) Only (II)
Information asset classification is a critical step that involves assigning sensitivity levels to resources to define appropriate access controls. This process is typically a foundational activity rather than the final step in an audit. By identifying and classifying assets based on their importance and sensitivity, banks can ensure that the most critical information receives the highest level of security.

59. (A) (I), (II), (III), and (IV)
Successful information security governance results in the alignment of security with business strategy, effective risk mitigation, and optimized investments. It also involves using performance metrics to measure success. While organizations may use third-party vendors, the complete outsourcing of all security components is not a standard desired outcome of governance, as internal oversight and accountability must always be maintained by the bank.

60. (C) (I) and (III)
Electronic banking channels must be issued only upon a customer's specific request and consent, not by force. Banks have a responsibility to sensitize these customers on protecting their security tokens and PINs. While promoting digital channels can reduce costs, forcing customers to use them is incorrect. Therefore, the mandates for customer choice and security education are the correct regulatory requirements.

61. (C) Security and privacy of the data hosted on the cloud.
When a bank uses a shared cloud environment for data analysis, its primary concern must be the security and privacy of its information. Because data resides on infrastructure owned by a third party and is accessed over the internet, ensuring unauthorized parties cannot access or intercept sensitive financial information is critical. This remains the most significant challenge in adopting cloud-based services.

62. (A) Conduct due diligence of the technology-related service provider and evaluate their role in relation to the IT environment.
When partnering with third-party service providers like MSPs, bank management is required to conduct thorough due diligence. This involves evaluating the vendor's capabilities and their specific role within the IT environment to ensure they meet security standards. Proper oversight of these technology partners is essential, as any security failure on their part can jeopardize the bank's entire infrastructure.

63. (C) Senior Management
While the Board of Directors approves information security policies, Senior Management is responsible for their actual implementation. This includes establishing the necessary organizational processes and providing the resources required for a strong cybersecurity posture. Senior Management's leadership is vital for translating high-level policy goals into effective, day-to-day security practices that protect the bank's information assets.

NODIA

64. (C) Assessment
An evaluation focused on locating security vulnerabilities and suggesting corrective actions without testing against a fixed set of formulated policies is defined as an assessment. This differs from an audit, which is a formal comparison against specific standards. Assessments provide a flexible way to understand the current security landscape and identify potential weaknesses that require technical or procedural remediation.

65. (B) Virtualization
Virtualization is the technology that allows multiple operating systems to run on a single piece of hardware, with each application having its own isolated environment. This approach optimizes hardware usage and provides stability by preventing problems in one virtual machine from affecting others. It is a more efficient alternative to the legacy practice of dedicating an entire physical server to a single application.

66. (D) Migration Policy
Moving vast amounts of sensitive customer data from a legacy system to a new platform requires a documented Data Migration Policy. This policy ensures data integrity, completeness, and confidentiality during the transition. It provides the framework for verifying that all information is transferred accurately and remains consistent, preventing data loss or unauthorized exposure throughout the complex migration process.

67. (D) Penetration Testing
Penetration testing is a formalized security measure where practitioners actively attempt to bypass security controls. The objective is to uncover weaknesses from an attacker's perspective before they can be exploited maliciously. This proactive testing helps organizations understand their real-world security resistance and provides a basis for strengthening defenses and improving the overall incident response capability of the bank.

68. (A) Compatibility and support
In virtualization projects, one of the primary operational challenges is ensuring that legacy applications can run in modern virtual environments. When old software fails to operate correctly within new application sandboxes, it is typically an issue of compatibility and support. Addressing these technical conflicts is essential for maintaining business continuity while upgrading to more efficient, virtualized IT infrastructures.

69. (B) Firewall
A firewall is a fundamental network protection device used in a defense in depth strategy. It monitors and filters incoming and outgoing network traffic based on an organization's predefined security rules. By acting as a barrier between trusted internal networks and untrusted external ones, firewalls prevent unauthorized access and protect banking systems from various internet-based threats and intrusions.

70. (B) Patch Management
Patch management is the systematic process of identifying, acquiring, deploying, and verifying software code revisions. Its goal is to fix discovered software flaws and vulnerabilities quickly to minimize potential business impact. By maintaining a structured approach to applying updates, banks can ensure their systems remain secure against known exploits and that software remains stable and correctly functioning.

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and commercial loans.
(D) No, because internal audit exclusively focuses on verifying physical properties, not financial controls.

Oct/Nov 2023

37. Match the BCBS Sound Corporate Governance Principles (List I) with their corresponding descriptions (List II).
List I: (Sound Corporate Governance Principles)
P. Principle 1
Q. Principle 2
R. Principle 3
S. Principle 4
List II: (Descriptions)
1. The board should ensure appropriate oversight by senior management consistent with board policy.
2. Board members should be qualified (fit and proper) and exercise sound judgment.
3. The board of directors should set and enforce clear lines of responsibility and accountability.
4. The board of directors should approve and oversee the bank's strategic objectives and corporate values.

(A) P-2, Q-4, R-3, S-1
(B) P-1, Q-3, R-2, S-4
(C) P-4, Q-2, R-3, S-1
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2020

38. Identify the correct statements regarding the Internal Audit function in a bank:
I It constitutes the third line of defence in the system of controls.
II Unlike the second line of defence, it shall not have any advisory role.
III The internal audit function shall not be outsourced entirely, but experts can be hired on a contractual basis if required.
IV The Head of Internal Audit (HIA) reports to the ACB to ensure functional independence.
Which of the above statement(s) is/are correct?
(A) Only (I), (II), and (III) are correct
(B) Only (II), (III), and (IV) are correct
(C) Only (I), (III), and (IV) are correct
(D) All (I), (II), (III), and (IV) are correct

Oct/Nov 2022

39. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R).
Assertion (A): Governance in the banking industry assumes wider proportions and criticality than in standard corporate entities.
Reason (R): A bank's recognized stakeholders include regulatory supervisors, governments, and depositors, and systemic risk can trigger a contagion effect.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2022

40. Which of the following pairs regarding committee meeting frequencies and gaps is INCORRECT?
(A) ACB meeting frequency - At least six times a year.
(B) RMCB meeting frequency - At least six times a year.
(C) ACB meeting gap - Not more than sixty days shall elapse between two meetings.
(D) RMCB meeting gap - Not more than ninety days shall elapse between two meetings.

Oct/Nov 2017

41. To ensure business alignment, Bank Beta decides to include the bank's CEO as a voting member of the ACB. Is this action compliant with corporate governance norms?
(A) Yes, because the CEO is ultimately responsible for the bank's results.
(B) No, because the ACB must be made up of only Non-Executive Directors.
(C) Yes, but only if the CEO holds an internationally recognized accounting certification.
(D) No, because the CEO must serve as the secretary and provide operational reports.

NODIA

overhead costs while maximizing the return on equity for the shareholders.
(B) Board members should be qualified for their positions, understand their roles, and exercise sound judgment about the affairs of the bank.
(C) Internal auditors must be physically fit to travel to all geographically separated branch locations and conduct surprise inspections of assets.
(D) Compensation policies must fit within the profit margins generated by the first line of defence to ensure the bank remains a going concern.

Oct/Nov 2018

7. How do the OECD principles fundamentally define corporate governance?
(A) The alignment of corporate activities with the expectation that banks will operate in a risk-free environment.
(B) A set of relationships between a company's management, its board, its shareholders, and other stakeholders.
(C) The systemic control utilized to mitigate risks and protect depositors' funds from liquidity crises.
(D) An independent compliance function responsible for ensuring the integrity of applicable laws.

May/June 2017

8. Identify the correct statement about the Risk Management Committee of the Board (RMCB).
(A) The RMCB is responsible for approving the quarterly, half-yearly, and annual financial statements.
(B) The RMCB is chaired by an independent director who shall not be a chair of any other committee of the Board.
(C) The Chief Compliance Officer (CCO) acts as the secretary to the RMCB during all its meetings.
(D) The RMCB is primarily responsible for establishing the whistle-blower policy and alert procedures.

Oct/Nov 2014

9. Which of the following is NOT a reason for the significant emphasis on corporate governance in the banking sector?
(A) Retail depositors cannot effectively protect themselves due to inadequate information.
(B) Banks rely exclusively on equity capital rather than deposits for daily operations.
(C) Bank assets are unusually opaque, lacking transparency and liquidity.
(D) A contagion effect from one unstable bank can affect the entire financial system.

May/June 2025

10. Which of the following correctly describes the "contagion effect" in the banking sector?
(A) A phenomenon where an increase in a bank's gearing ratio proportionally increases returns to depositors while maintaining stability.
(B) An operational capability of the internal audit function to identify emerging risks across geographically separated branch offices.
(C) A process where poor governance in one bank triggers systemic risk, impacting other banks through mutual lending and borrowing.
(D) A top-down communication strategy used by the board to establish a strong risk culture that aligns with long-term strategic goals.

Oct/Nov 2012

11. Arrange the following logical steps a board must take regarding conflicts of interest in the correct sequence:
I Communicate any material actual/potential/perceived conflicts of interest to the board
II Implement adequate policies to identify actual/potential/perceived conflicts of interest
III Decide on mitigating measures
IV Assess the materiality of the identified conflicts
(A) (II), (IV), (III), (I)
(B) (I), (II), (III), (IV)
(C) (IV), (II), (I), (III)
(D) (II), (I), (IV), (III)

Oct/Nov 2008

12. How much time must every employee in the bank spend annually reviewing a conduct training manual before signing the code of conduct statement?

NODIA

industry's biggest source of funds but have very little or no say in management.
(D) The failure of a single bank can have broader macroeconomic implications and substantial public costs.

May/June 2015

26. What does the term "acquisition" signify in the context of corporate structural changes?
(A) A process where two companies of similar size merge to form a new enterprise with a unified board and joint asset management.
(B) The internal allocation of risk limits across various business units by the RMCB to ensure adherence to the overall risk appetite.
(C) The formal induction of new independent directors onto a bank's board to satisfy regulatory requirements for diverse board composition.
(D) An event where one company purchases a controlling interest in another company by acquiring a majority of its outstanding shares.

Oct/Nov 2007

27. Which of the following best describes the primary purpose of a credible whistle-blower policy?
(A) To permit employees and third parties to report concerns about unethical behavior, misconduct, or suspected fraud safely and confidentially.
(B) To allow the CEO and senior management to monitor the daily attendance, punctuality, and performance metrics of the bank's frontline employees.
(C) To act as a strategic public relations tool ensuring the bank receives positive ratings from external credit rating agencies and shareholders.
(D) To replace the internal audit function by crowdsourcing compliance reviews from the general staff to identify potential operational inefficiencies.

May/June 2018

28. What does the concept of "tone at the middle" imply in a bank's governance framework?
(A) A system ensuring that espoused values are promoted by management and staff at all levels, aligning with the board's expectations.
(B) The exclusive responsibility of the CEO and senior management to draft the bank's values, conduct manual, and internal guidelines.
(C) The delegation of statutory compliance tasks to mid-level management to free up the board's time for strategic decision-making.
(D) The physical and functional segregation of risk origination in the front office from risk underwriting and monitoring in mid-office.

Oct/Nov 2013

29. Which of the following is NOT typically listed as one of the six primary Principles of Corporate Governance?
(A) Fairness
(B) Transparency
(C) Profit Maximization
(D) Integrity

Oct/Nov 2009

30. Identify the correct statement regarding the role and hierarchy of the Chief Risk Officer (CRO).
(A) The CRO operates as part of the first line of defence to ensure business lines meet their revenue targets.
(B) The CRO possesses full sanctioning authority to assume risk independent of the management committee.
(C) The CRO can be prematurely removed by the CEO without any public disclosure or board approval.
(D) The CRO shall be a senior official with equivalence no less than those at one level below the WTDs/CEO.

Oct/Nov 2025

31. Which of the following pairs linking a regulatory concept to its purpose is CORRECT?
(A) Punitive vigilance - Forecasting the market risk trends for the upcoming financial year to adjust the overall risk appetite.
(B) Gearing ratio - Measuring the exact time an employee spends on conduct training before signing the code of conduct manual.
(C) Fit and proper principle - Ensuring board members have a clear understanding, qualification, and sound judgment.

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NODIA

May/June 2006

19. Identify the incorrect statement regarding the board's responsibilities over conflicts of interest.

(A) The board must ensure adequate policies are implemented to identify actual, potential, or perceived conflicts of interest.

(B) Directors must disclose any matter that may result in a conflict of interest, and abstain from voting on such matters.

(C) A formal written policy is required, demonstrating that related party transactions are undertaken on an arm's length basis.

(D) Conflicts of interest only arise between a bank and its external retail depositors, not between directors and the bank.

May/June 2012

20. Identify the correct statement regarding the internal audit function in a bank.

(A) The internal audit function shall not have any advisory role and serves as the third line of defence.

(B) The internal audit function is considered the second line of defence and provides active advisory services to business units.

(C) Internal audit reports must be filtered by senior management before being made available to the ACB.

(D) The internal audit function can be entirely outsourced to an external audit firm without any internal ownership.

May/June 2020

21. Arrange the following corporate governance guidelines and frameworks in the correct chronological sequence of their publication/ issuance:

I Basel Committee Principles for enhancing corporate governance

II Reserve Bank of India Discussion paper on Governance in Commercial Banks

III Basel Committee paper "Enhancing corporate governance for banking organizations"

(A) (I), (II), (III)
(B) (III), (I), (II)
(C) (II), (III), (I)
(D) (III), (II), (I)

May/June 2009

22. What is the minimum required frequency for the meetings of the Audit Committee of the Board (ACB)?

(A) At least four times a year with not more than ninety days elapsing between two meetings.

(B) At least six times a year with not more than sixty days elapsing between two meetings.

(C) At least eight times a year with not more than forty-five days elapsing between two meetings.

(D) At least twelve times a year with not more than thirty days elapsing between two meetings.

May/June 2021

23. Under the "three lines of defence" model, what does "ownership" of risk fundamentally mean?

(A) The internal audit team independently verifying the accuracy of risk mitigation strategies.

(B) The compliance function routinely monitoring adherence to applicable statutes and governance codes.

(C) The board of directors assuming full liability for any financial losses suffered by retail depositors.

(D) The business line acknowledging and managing the risks that it incurs while conducting its daily activities.

May/June 2016

24. The vigilance function of a bank broadly includes all of the following domains EXCEPT:

(A) Preventive vigilance
(B) Surveillance and detection
(C) Punitive vigilance
(D) Credit underwriting and appraisal

May/June 2023

25. Identify the incorrect statement regarding the banking industry's stakeholders and governance.

(A) The banking sector depends heavily on public trust and confidence for its proper functioning and growth.

(B) Shareholders are the only recognized stakeholders whose concerns a bank's governance structure must address.

(C) Depositors represent the banking

CHAPTER 21
Corporate Governance

May/June 2014

1. What is the financial threshold for frauds that triggers the mandatory requirement for the Audit Committee of the Board (ACB) to monitor and review systemic lacunae?
(A) Rs. 50 Lakhs and above
(B) Rs. 1 Crore and above
(C) Rs. 5 Crores and above
(D) Rs. 10 Crores and above

Oct/Nov 2005

2. Identify the incorrect statement regarding the internal vigilance function.
(A) The vigilance function broadly includes preventive vigilance, surveillance and detection, and punitive vigilance.
(B) The budget of the vigilance function shall be recommended by the ACB and approved by the board.
(C) The vigilance function is headed by the Chief of Internal Vigilance (CIV), who reports directly to the CEO.
(D) Systematic annual assessments shall be undertaken on whether employees are aware of escalation processes.

Oct/Nov 2019

3. How is corporate governance in banks defined from the Basel Committee on Banking Supervision (BCBS) perspective?
(A) The regulatory mechanism that ensures bank deposits earn a high return despite low deposit insurance availability.
(B) The exclusive oversight of a bank's financial reporting process by an independent audit committee.
(C) The manner in which the business and affairs of banks are governed by their board of directors and senior management.
(D) The alignment of competitive strategies with the regulatory landscape to maximize shareholder wealth.

May/June 2011

4. Which is the most appropriate description of a bank's "Risk Appetite"?
(A) The maximum absolute loss a bank's balance sheet can absorb before entering bankruptcy and requiring an immediate regulatory bailout.
(B) The sum of all non-performing assets recognized by the external statutory auditors during the annual review of the bank's loan portfolio.
(C) The boundaries and types of risk a bank is willing to assume to achieve its business activities within its risk capacity.
(D) The regulatory capital requirement mandated by the central bank to ensure systemic stability and maintain public confidence in the sector.

Oct/Nov 2021

5. What does "agency risk" represent in the context of corporate governance?
(A) The risk that regulatory supervisors will intervene in the bank's day-to-day operations and impose additional capital requirements.
(B) The risk that management, acting as an agent, makes decisions that do not align with the best interests of the company's shareholders.
(C) The financial risk associated with hiring external audit agencies to perform statutory audits and verify the accuracy of the balance sheet.
(D) The operational risk arising from delegating critical third-party services to external vendors without implementing proper oversight.

May/June 2005

6. Which of the following is the best description of the "Fit and Proper" principle?
(A) Senior management must maintain an operational structure that minimizes

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(D) Contagion effect - A mechanism to systematically prevent whistle-blower identities from leaking during the investigation process.

May/June 2019

32. The ACB reviews the financial statements and auditor's report with the management before submission to the board with reference to which of the following?

I Changes, if any, in accounting policy and practices.
II Major accounting entries involving estimates based on management judgment.
III Compliance with listing, disclosure, and other legal requirements.
IV Disclosure of related party transactions.
V The marketing strategy for new liability products.

(A) Only (I), (II), (III), and (V) are correct
(B) Only (I), (II), (III), and (IV) are correct
(C) Only (II), (III), (IV), and (V) are correct
(D) All (I), (II), (III), (IV), and (V) are correct

Oct/Nov 2011

33. Match the executive functionaries (List I) with their designated reporting structure or characteristic (List II).

List I: (Executive Functionaries)
P. Chief Risk Officer (CRO)
Q. Chief Compliance Officer (CCO)
R. Head of Internal Audit (HIA)
S. Chief of Internal Vigilance (CIV)

List II: (Characteristics)
1. Accountable and reports only to the board through the ACB; premature removal requires board approval.
2. Reports to the ACB; ensures operations maintain integrity with applicable laws.
3. Functions as secretary to the RMCB; equivalence no less than one level below WTDs/CEO.
4. Reporting line shall be to the ACB; handles preventive and punitive actions.

(A) P-4, Q-1, R-3, S-2
(B) P-3, Q-2, R-1, S-4
(C) P-2, Q-4, R-1, S-3
(D) P-1, Q-3, R-2, S-4

NODIA

May/June 2010

34. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R).

Assertion (A): Depositors typically have a major say in the day-to-day management and strategic decision-making of the bank.

Reason (R): Bank deposits are subject to a fairly high gearing ratio, which adds risks to the depositors' funds, leaving them vulnerable to capital encroachments.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2024

35. Consider the following statements regarding the removal of the Chief Risk Officer (CRO):

I The CRO can be removed prematurely by the RMCB without requiring the prior approval of the board.
II The reasons for any premature removal of the CRO must be disclosed publicly and to relevant supervisory departments.

Which of the above statement(s) is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2006

36. Following the default at Bank Alpha, the CEO blamed the internal audit team for not preventing the risky loans from being sanctioned. Is the CEO's assertion correct based on standard governance principles?

(A) No, because internal audit provides retrospective objective assurance, not preventive operational control.
(B) (B) Yes, because internal audit represents the first line of defence responsible for preventing daily errors.
(C) Yes, because internal audit holds the direct sanctioning authority for all retail

(A) At least 30 minutes
(B) At least 45 minutes
(C) At least 60 minutes
(D) At least 90 minutes

Oct/Nov 2016

13. Identify the incorrect statement about the Chief Compliance Officer (CCO).
(A) The CCO is permitted to assume revenue generation responsibilities within the first line of defence to integrate compliance into operations.
(B) The CCO shall have the overall responsibility for the identification, management, and mitigation of the bank's enterprise-wide compliance risk.
(C) The CCO's performance appraisal and selection fall under the oversight of the ACB to ensure the independence of the compliance function.
(D) The CCO must hold a hierarchy equivalence no less than those at one level below the Whole-Time Directors or one level below the CEO.

May/June 2013

14. Identify the correct statement regarding the constitution of the Audit Committee of the Board (ACB).
(A) The ACB must be chaired by the chairperson of the bank to ensure executive alignment.
(B) The head of the internal audit function shall function as a voting member of the ACB.
(C) The ACB shall be made up of only Non-Executive Directors (NEDs) with a quorum requiring 2/3 to be independent directors.
(D) The ACB can include up to two Whole-Time Directors (WTDs) provided they are financially literate.

May/June 2008

15. What is the most appropriate role of the finance function within the risk governance framework?
(A) It acts as the ultimate third line of defence by conducting independent surveillance on the CEO and the board's strategic financial planning process.
(B) It manages the punitive vigilance system by attributing direct financial penalties to employees who breach risk limits and internal conduct codes.
(C) It formulates the compliance policy of the bank independently of the Chief Compliance Officer to ensure financial targets are integrated with ethics.
(D) It serves as a key input to risk decisions by ensuring business performance is accurately reported, despite being part of the first line of defence.

Oct/Nov 2024

16. What does "compliance risk" specifically represent in the context of banking governance?
(A) The risk of legal sanctions, financial loss, or reputation damage resulting from non-compliance with laws and rules.
(B) The risk of systemic contagion affecting global payment systems caused by a major counterparty failure in the market.
(C) The probability of agency risk escalating when management decisions contradict shareholder interests and lead to loss.
(D) The financial loss resulting from inadequate organizational structures in the first line of defence during volatility.

Oct/Nov 2010

17. Which of the following is NOT a required component of a bank's Risk Appetite Statement (RAS)?
(A) It must completely eliminate the possibility of any business line incurring operational risk.
(B) It must include both quantitative and qualitative considerations.
(C) It must establish the types of risk the bank is willing to assume in advance.
(D) It must communicate the risk appetite effectively, linking it to daily operational decision-making.

May/June 2007

18. In which month and year did the Basel Committee on Banking Supervision (BCBS) publish the paper titled "Enhancing corporate governance for banking organizations"?
(A) October 2010
(B) April 2007
(C) February 2006
(D) June 2020

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Oct/Nov 2015

42. Match the terminology related to risk governance (List I) with its definition (List II).
List I: (Risk Governance Terminology)
P. Risk Appetite
Q. Risk Capacity
R. Conduct Risk
S. Tone at the top
List II: (Definitions)
1. The board playing a lead role in establishing the bank's culture and adhering to ethical values.
2. The risk of legal/regulatory sanctions or reputation loss from unethical behavior or statutory failures.
3. The types of risk a bank is willing to assume in advance to achieve business activities.
4. The maximum amount of risk a bank can bear given its operational and financial constraints.
(A) P-4, Q-3, R-1, S-2
(B) P-1, Q-2, R-4, S-3
(C) P-3, Q-4, R-2, S-1
(D) P-2, Q-1, R-3, S-4

May/June 2016

43. Which of the following are responsibilities of the Chief Risk Officer (CRO)?
I Managing or participating in key decision-making processes such as strategic and capital planning.
II Assuming revenue generation targets to align risk mitigation with profitability.
III Articulating risk in an understandable manner in constructive dialogue with the board.
IV Functioning as a secretary to the RMCB.
Which of the above statement(s) is/are correct?
(A) Only (I), (II), and (III) are correct
(B) Only (II), (III), and (IV) are correct
(C) Only (I), (III), and (IV) are correct
(D) All (I), (II), (III), and (IV) are correct

Oct/Nov 2009

44. Consider the following statements regarding the Audit Committee of the Board (ACB):
I All members of the ACB shall be financially literate.
II The head of the internal audit function shall act as the secretary to the ACB.
III The ACB must review and approve the appointment of the Chief Risk Officer (CRO).
Which of the above statement(s) is/are correct?
(A) Only (I) and (II) are correct
(B) Only (II) and (III) are correct
(C) Only (I) and (III) are correct
(D) All (I), (II), and (III) are correct

May/June 2023

45. In the Bank Alpha scenario, the risk management department identified deteriorating credit quality but lacked the authority to challenge the business line managers. This indicates a failure in which specific governance expectation?
(A) Ensuring the internal audit function conducts daily operational reviews of all retail loans.
(B) Prohibiting the compliance function from reporting directly to the RMCB or the board chair.
(C) Ensuring the second line of defence has sufficient authority, stature, and independence.
(D) Mandating the first line of defence to draft the statutory audit reports and annual statements.

Oct/Nov 2018

46. Match the Three Lines of Defence (List I) with their respective roles (List II).
List I: (Three Lines of Defence)
P. First line of defence (Business line)
Q. Second line of defence (Risk Management)
R. Second line of defence (Compliance)
S. Third line of defence (Internal Audit)
List II: (Roles)
1. Provides independent review and objective assurance on the overall governance framework.
2. Acknowledges and manages the risks it incurs, holding "ownership" of the risk.
3. Routinely monitors observance of applicable statutes and manages 'compliance risk'.
4. Identifies, measures, monitors, and reports risk independently on an enterprise-wide basis.
(A) P-1, Q-2, R-4, S-3

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Oct/Nov 2005

68. To ensure the risk department at Bank Delta is profitable, the CEO assigns revenue-generating targets to the CRO. Is it appropriate for the CRO to have revenue-generating targets under corporate governance guidelines?

(A) No, because risk management functionaries should not have revenue generating responsibilities.

(B) Yes, as long as the targets do not exceed the targets set for the commercial business line.

(C) Yes, because all second-line defence functions must be self-sustaining through fee income.

(D) No, because the CRO's targets must be set by the external auditors to ensure true neutrality.

May/June 2020

69. Read the following scenario and answer the question that follows.

If the reporting employee's identity at Bank Gamma is accidentally revealed by the vigilance team, leading to retaliation against the employee by the branch manager, which key principle of the whistle-blower policy has been violated?

(A) The principle requiring systemic tracking of all risk limit breaches in the first line.

(B) The guarantee of confidentiality and protection from victimisation or unfair treatment.

(C) The principle that all employees must complete 60 minutes of mandatory conduct training.

(D) The requirement that whistle-blowing must bypass all existing protected disclosure schemes.

Oct/Nov 2015

70. Following the regulatory penalties at Bank Epsilon, the CEO decides to prematurely dismiss the CCO for the failure without consulting the board. Under corporate governance norms, is the CEO permitted to do this?

(A) Yes, the CEO holds absolute authority over second-line defence functionaries regarding their employment.

(B) No, premature removal of the CCO shall only be with prior board approval and must be disclosed publicly.

(C) Yes, provided the CEO informs the statutory auditor within 60 days of the dismissal for the sake of audit.

(D) No, the CCO can only be removed by the central regulatory authority to maintain functional independence.

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cannot chair the RMCB without executive oversight.
(D) No, because the chair of the ACB shall not chair any other committee of the Board.

Oct/Nov 2006

52. Which of the following pairs of a board committee and its composition requirement is CORRECT?
(A) ACB - Must include the CEO and at least one executive director.
(B) ACB - Has a quorum requirement of five members, all being executive directors.
(C) RMCB - Exclusively comprised of members from the first line of defence.
(D) RMCB - Chaired by an independent director who is not a chair of any other committee.

May/June 2021

53. Consider the following statements regarding the Compliance Function:
I The compliance function is part of the second line of defence and must be independent of any responsibilities related to the first line of defence.
II Compliance risk includes the risk of material financial loss or reputation loss a bank may suffer due to failure to comply with laws and regulations.
Which of the above statement(s) is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2010

54. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R).
Assertion (A): The internal audit function in a bank shall not be entrusted with any advisory role.
Reason (R): Internal auditors must actively participate in developing, implementing, and operating the first line of defence functions to ensure operational efficiency.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2005

55. Which of the following statements correctly describe the Vigilance function in a bank?
I The vigilance functions broadly include preventive vigilance, surveillance and detection, and punitive vigilance.
II Advanced analytics shall be implemented to capture employee-specific information such as updates of income and wealth.
III The Chief of Internal Vigilance (CIV) reports directly to the ACB.
IV The CIV's budget is recommended jointly by the RMCB and the NRC.
Which of the above statement(s) is/are correct?
(A) Only (I), (II), and (III) are correct
(B) Only (II), (III), and (IV) are correct
(C) Only (I), (III), and (IV) are correct
(D) All (I), (II), (III), and (IV) are correct

Oct/Nov 2022

56. Match the Principles of Corporate Governance (List I) with their core meanings (List II).
List I: (Principles of Corporate Governance)
P. Fairness
Q. Transparency
R. Integrity
S. Accountability
List II: (Core Meanings)
1. Explaining the purpose of a company's activities and the results of its conduct.
2. Treating shareholders, employees, vendors, and communities with equal consideration.
3. Openness forming the basis for confidence between business and stakeholders.
4. Straightforward dealing, completeness, and presenting a balanced picture of affairs.
(A) P-2, Q-3, R-4, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-1, Q-2, R-3, S-4
(D) P-4, Q-1, R-2, S-3

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(B) P-2, Q-4, R-3, S-1
(C) P-3, Q-1, R-2, S-4
(D) P-4, Q-3, R-1, S-2

May/June 2007

47. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R).
Assertion (A): Risk management functionaries, including the CRO, should be delegated the absolute authority to sanction and assume risk on behalf of the bank.
Reason (R): The risk management function provides independent assurance to the board without management filtering.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2025

48. Which of the following pairs of risk control mechanisms and their descriptions is INCORRECT?
(A) First line of defence - Business line acknowledging and managing the risk it incurs.
(B) Second line of defence - Internal audit providing independent review and objective assurance.
(C) Third line of defence - Independent vigilance function minimizing the scope of malpractices.
(D) Second line of defence - Independent risk management and compliance functions.

May/June 2012

49. When overseeing senior management, the board's responsibilities include which of the following?
I Meeting regularly with senior management.
II Undertaking a formal interaction with senior management functionaries who are not directors, at least once every year, through independent directors.
III Setting appropriate performance and remuneration standards consistent with long-term strategic objectives.
IV Assessing whether senior management's collective knowledge and expertise remain appropriate.
V Actively engaging in succession plans for the CEO and other key positions.
(A) Only (I), (III), (IV), and (V) are correct
(B) Only (II), (III), (IV), and (V) are correct
(C) Only (I), (II), (III), and (IV) are correct
(D) All (I), (II), (III), (IV), and (V) are correct

Oct/Nov 2014

50. Consider the following statements regarding the Risk Management Committee of the Board (RMCB):
I The RMCB is made up of only Non-Executive Directors (NEDs) with a quorum requiring 2/3 independent directors.
II The CRO shall function as the secretary of the RMCB and will report into the committee.
III The RMCB acts as the third line of defence to provide objective assurance on internal controls.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II) are correct
(B) Only (II) and (III) are correct
(C) Only (I) and (III) are correct
(D) All (I), (II), (III), and (IV) are correct

NODIA

May/June 2019

51. Read the following scenario and answer the question that follows.
Bank Beta is restructuring its board committees. The board appoints Mr. Sharma, an experienced independent director, as the chair of the Audit Committee of the Board (ACB). To streamline decision-making, the board also appoints Mr. Sharma as the chair of the Risk Management Committee of the Board (RMCB).
Does this comply with the corporate governance guidelines?
(A) Yes, because streamlining decision-making is a core principle encouraged by the BCBS.
(B) Yes, provided Mr. Sharma is financially literate and has experience in banking audits.
(C) No, because an independent director

from occurring.
(C) Delegate the investigation to an external statutory auditor and absolve internal vigilance teams.
(D) Revise the bank's capital adequacy ratio and report the findings to the shareholders and media.

May/June 2009

63. During the restructuring at Bank Beta, what is the minimum required proportion of independent directors for both the ACB and RMCB to meet a valid quorum?
(A) One-half (1/2) of the members must be independent directors.
(B) One-third (1/3) of the members must be independent directors.
(C) Two-thirds (2/3) of the members must be independent directors.
(D) Three-fourths (3/4) of the members must be independent directors.

Oct/Nov 2011

64. How should compliance with host country legal requirements be handled when a bank operates across multiple jurisdictions?
(A) The bank should only adhere to home-country regulations to maintain standardization across all branches.
(B) The board must absolve the CCO of any responsibility for foreign operations to avoid legal jurisdiction.
(C) The compliance function must be consistent with host country requirements, with oversight by the CCO.
(D) The business line manager in the host country must assume the role of the CCO for local statutory filing.

May/June 2010

65. Read the following scenario and answer the question that follows.
Bank Delta is drafting its Risk Appetite Statement (RAS). The Chief Risk Officer (CRO) unilaterally drafts the RAS and sets the risk limits without consulting the business units or the board.
How should the development of an effective RAS ideally be driven according to the governance framework?
(A) Exclusively by the third line of defence to ensure independent oversight.
(B) By both top-down board leadership and bottom-up management involvement.
(C) By the external statutory auditors to ensure objectivity and transparency.
(D) Unilaterally by the CRO to avoid any conflicts of interest with the board.

Oct/Nov 2024

66. Read the following scenario and answer the question that follows.
An employee at Bank Gamma notices a branch manager systematically sanctioning fraudulent loans amounting to Rs. 2.5 Crores. The employee uses the bank's internal whistle-blowing mechanism to report the fraud.
Based on standard banking governance financial thresholds, is the ACB required to review this specific fraud case?
(A) No, the ACB only reviews frauds above Rs. 10 Crores.
(B) No, frauds should exclusively be handled by the RMCB regardless of the amount.
(C) Yes, because it involves a fraud of Rs. One Crore and above.
(D) Yes, because all frauds, regardless of amount, must be reviewed directly by the ACB.

May/June 2017

67. Read the following scenario and answer the question that follows.
Bank Epsilon plans to launch a complex cross-border derivative product. The business head secures immediate approval from the CEO to launch the product. The Chief Compliance Officer (CCO) is only informed post-launch.
What proactive step should the compliance function have taken according to governance standards?
(A) Advised the internal audit team to conduct a retrospective review of the derivative's risk.
(B) Delegated the approval authority exclusively to the external regulatory supervisors of the bank.
(C) Ensured the product generated sufficient revenue before intervening in the board's decision.
(D) Put in place an approval process for all new processes and products by the compliance function.

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engage in revenue-generating activities. Ownership of risk means these units are responsible for identifying and managing the risks associated with their daily operations. By taking accountability for these risks, business lines ensure that mitigation strategies are integrated into the core processes of the bank.

24. (D) Credit underwriting and appraisal
The internal vigilance function is a specialized control mechanism focused on preventing and detecting misconduct. It encompasses three primary domains: preventive measures to reduce opportunities for malpractice, surveillance to detect ongoing irregularities, and punitive actions against confirmed offenders. Activities like credit underwriting fall under regular business operations and risk management functions rather than the specialized scope of the vigilance department.

25. (B) Shareholders are the only recognized stakeholders whose concerns a bank's governance structure must address.
Banking governance must account for a wide range of stakeholders due to the systemic importance of financial institutions. While shareholders provide capital, they are not the only party of concern. Depositors, who provide the majority of funding, have limited control over management but are highly vulnerable. Therefore, boards must also consider the interests of regulators, governments, and the public.

26. (D) An event where one company purchases a controlling interest in another company by acquiring a majority of its outstanding shares.
In corporate finance and governance, an acquisition occurs when one entity obtains a controlling interest in another. This is typically achieved by purchasing a majority of the target company's outstanding shares. Unlike a merger, where two companies combine to form a new entity, an acquisition results in the acquired company becoming a subsidiary or being absorbed by the purchasing organization.

27. (A) To permit employees and third parties to report concerns about unethical behavior, misconduct, or suspected fraud safely and confidentially.
A whistle-blower policy is a vital governance tool that empowers employees and stakeholders to report unethical conduct or fraud safely. By providing confidential channels for communication, it encourages the disclosure of hidden risks without fear of retaliation. This mechanism supports a culture of transparency and acts as an early warning system, helping the board identify and address internal irregularities.

28. (A) A system ensuring that espoused values are promoted by management and staff at all levels, aligning with the board's expectations.
Tone at the middle refers to the critical role of mid-level management in propagating the ethical values set by the board. While the board establishes the "tone at the top," middle managers must ensure these values are integrated into daily operations. This ensures that all staff members adhere to the code of conduct, creating a consistent culture of integrity.

29. (C) Profit Maximization
Corporate governance is built upon several foundational principles designed to ensure organizational health and ethical conduct. These include fairness toward all stakeholders, transparency in reporting, integrity in dealings, and accountability for results. While banks strive for financial success, profit maximization is a business objective rather than a core principle of governance, as it must be balanced against safety.

30. (D) The CRO shall be a senior official with equivalence no less than those at one level below the WTDs/CEO.
The Chief Risk Officer must hold a high-ranking position within the bank to ensure sufficient authority and independence. Guidelines specify that this officer's hierarchy must be no less than one level below the whole-time directors or the chief executive officer. This status enables the officer to challenge business decisions effectively and ensures that risk-related concerns are heard at the highest levels.

NODIA

ANSWERS

1. (B) Rs. 1 Crore and above
The Special Committee of the Board for Monitoring and Follow-up of Frauds plays a critical role in supervising the response to significant fraudulent activities. Regulatory guidelines mandate that for any fraud amounting to one crore rupees or more, the committee must conduct a thorough review. This involves identifying systemic weaknesses and implementing corrective measures to prevent future occurrences while ensuring overall financial stability and accountability.

2. (C) The vigilance function is headed by the Chief of Internal Vigilance (CIV), who reports directly to the CEO.
Effective internal vigilance within banking institutions is designed to maintain organizational integrity. This function is overseen by the Chief of Internal Vigilance, who maintains functional independence by reporting directly to the Audit Committee of the Board rather than the executive leadership. This reporting structure ensures that surveillance, detection, and punitive measures remain objective and free from executive interference.

3. (C) The manner in which the business and affairs of banks are governed by their board of directors and senior management.
Corporate governance in the banking sector encompasses the framework through which institutions are directed and controlled. According to the Basel Committee, it specifically refers to the processes by which the board of directors and senior management govern business affairs. This structure ensures that strategic objectives are met while maintaining safety, soundness, and compliance with prevailing regulatory standards.

4. (C) The boundaries and types of risk a bank is willing to assume to achieve its business activities within its risk capacity.
A bank's risk appetite defines the level of risk the institution is prepared to accept to meet its strategic goals. It establishes clear boundaries for different types of risks within the bank's overall capacity. This framework ensures that business activities align with the board's expectations and that the organization maintains sufficient capital to absorb potential unexpected financial losses.

5. (B) The risk that management, acting as an agent, makes decisions that do not align with the best interests of the company's shareholders.
Agency risk arises from the inherent conflict between the interests of a company's owners and its management. In corporate governance, this occurs when managers, acting as agents, prioritize their personal goals over the objectives of the shareholders. Addressing this risk requires robust oversight mechanisms to ensure that executive decisions consistently align with the long-term interests of the organization.

6. (B) Board members should be qualified for their positions, understand their roles, and exercise sound judgment about the affairs of the bank.
The fit and proper principle is a fundamental pillar of banking governance. It requires that all board members possess the necessary qualifications, experience, and integrity to fulfill their duties. Directors must demonstrate a sound understanding of the bank's operations and exercise independent judgment. This ensures that the leadership remains capable of steering the institution toward stability and regulatory compliance.

7. (B) A set of relationships between a company's management, its board, its shareholders, and other stakeholders.
The Organization for Economic Cooperation and Development defines corporate governance as a multifaceted system of relationships. This framework involves interactions between an organization's management, its board of directors, shareholders, and various other stakeholders. It provides the structure for setting objectives, determining the means to attain them, and monitoring performance to

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May/June 2018

57. Read the following scenario and answer the question that follows.

Bank Alpha aggressively expanded its retail lending portfolio to boost revenue. The retail lending department bypassed several credit checks to meet targets, resulting in massive defaults.

According to the "three lines of defence" framework, which entity had the primary "ownership" of this risk and should be held accountable for the initial breaches?

(A) The Retail Lending Department (Business Line)
(B) The Risk Management Department
(C) The Internal Audit Function
(D) The Audit Committee of the Board (ACB)

Oct/Nov 2016

58. Consider the following statements regarding the role of the finance function:

I The finance function is part of the first line of defence and plays a critical role in ensuring business performance is accurately recognized as a key input to risk decisions.
II The finance function must not have any access to the board in order to maintain the absolute independence of the second line of defence.

Which of the above statement(s) is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2014

59. The bank's internal alert (whistle-blower) procedures must ensure which of the following specific aspects?

I Confidentiality is guaranteed in all cases unless disclosure is required by law in subsequent judicial proceedings.
II Confirmation of receipt to the staff who raised potential or actual breaches is provided.
III Staff raising internal flags are publicly rewarded to encourage others, disclosing their identity.
IV There are clear timelines for taking appropriate actions for the breaches reported.
V There is a provision to escalate to the chair of the ACB and, if it persists, to the chair of the board.

Which of the above statement(s) is/are correct?

(A) Only (I), (II), (IV), and (V) are correct
(B) Only (I), (III), (IV), and (V) are correct
(C) Only (II), (III), (IV), and (V) are correct
(D) All (I), (II), (III), (IV), and (V) are correct

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Oct/Nov 2007

60. Which of the following are responsibilities of the Board to reinforce a strong "culture and values"?

I Implementing an online process by which every employee spends at least 60 minutes annually reviewing a conduct training manual.
II Ensuring that assessment of adherence to the bank's values is factored into the performance appraisal system.
III Taking an active role in defining the risk appetite, ensuring its alignment with strategic and capital plans.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II) are correct
(B) Only (II) and (III) are correct
(C) Only (I) and (III) are correct
(D) All (I), (II), and (III) are correct

May/June 2025

61. To guarantee independence and proper oversight, to whom should the CRO of Bank Delta primarily report?

(A) The Chief Executive Officer (CEO)
(B) The Audit Committee of the Board (ACB)
(C) The Risk Management Committee of the Board (RMCB)
(D) The Head of Internal Audit (HIA)

Oct/Nov 2019

62. Upon receiving the report of the Rs. 2.5 Crore fraud at Bank Gamma, what specific action must the ACB take regarding the systemic implications?

(A) Identify the systemic lacunae that facilitated the fraud and put in place measures to plug the same.
(B) Immediately dismiss the Chief Compliance Officer for failure to prevent the fraud

risk management framework. It is responsible for ensuring that business performance and financial data are reported accurately. This accuracy is essential for senior management and risk officers to make informed decisions, as it provides a realistic view of the bank's current financial position.

16. (A) The risk of legal sanctions, financial loss, or reputation damage resulting from non-compliance with laws and rules.
Compliance risk refers to the potential for legal penalties, financial losses, or damage to reputation due to failure to follow laws, regulations, and ethical standards. In a banking context, this risk encompasses adherence to statutory requirements and internal policies. Effective management of this risk is crucial for maintaining public trust and ensuring that the institution operates within the regulatory framework.

17. (A) It must completely eliminate the possibility of any business line incurring operational risk.
A Risk Appetite Statement must be comprehensive and practical, incorporating both qualitative and quantitative measures. It outlines the specific risks a bank is prepared to take. While it guides operational decisions and identifies limits, it cannot completely eliminate all risks, such as operational risk. Instead, it ensures that these risks are identified, measured, and managed within total capacity.

18. (C) February 2006
In February 2006, the Basel Committee on Banking Supervision issued a pivotal guidance paper titled "Enhancing corporate governance for banking organizations." This document provided international standards for strengthening board oversight, risk management, and internal controls. It emphasized the importance of transparency and accountability, serving as a foundation for many of the corporate governance regulations adopted by central banks worldwide.

19. (D) Conflicts of interest only arise between a bank and its external retail depositors, not between directors and the bank.
Corporate governance requires directors to act in the best interest of the bank, which involves managing various conflicts of interest. These conflicts can occur internally between directors and the institution, not just with external parties. Board members must disclose any personal interests and abstain from relevant decisions. Formal policies ensure that all transactions are conducted on an arm's length basis.

20. (A) The internal audit function shall not have any advisory role and serves as the third line of defence.
The internal audit function serves as the third line of defence, providing independent and objective assurance on the effectiveness of internal controls. To maintain its independence, this function must not have any operational or advisory roles that could compromise its objectivity. It reports directly to the Audit Committee of the Board, ensuring that its findings are communicated without management filtering.

21. (B) (III), (I), (II)
Regulatory frameworks for bank governance have evolved over time to address emerging risks. The Basel Committee first published its foundational paper in 2006, followed by a revised set of principles in 2015. More recently, in 2020, the Reserve Bank of India issued a comprehensive discussion paper. Following this chronological order ensures an understanding of how governance standards have matured globally.

22. (B) At least six times a year with not more than sixty days elapsing between two meetings.
Regular oversight is essential for the Audit Committee of the Board to fulfill its mandate effectively. Guidelines require the committee to meet at least six times annually. To ensure consistent monitoring of financial reporting and internal controls, no more than sixty days should elapse between any two meetings. This frequency allows the committee to respond promptly to emerging financial issues.

23. (D) The business line acknowledging and managing the risks that it incurs while conducting its daily activities.
Within the three lines of defence model, the first line consists of business units that directly

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ensure transparency, accountability, and long-term sustainability.

8. (B) The RMCB is chaired by an independent director who shall not be a chair of any other committee of the Board.
The Risk Management Committee of the Board is responsible for overseeing the bank's risk-taking activities. To ensure independence and specialized oversight, this committee must be chaired by an independent director. Furthermore, the chairperson of this committee is prohibited from chairing any other board committee. This restriction prevents conflicts of interest and ensures dedicated focus on the bank's risk governance.

9. (B) Banks rely exclusively on equity capital rather than deposits for daily operations.
Banking governance is exceptionally critical due to the industry's unique characteristics, such as the reliance on public deposits and the potential for systemic contagion. Unlike most corporate entities, banks primarily operate using depositors' funds rather than just equity capital. Therefore, strong governance is necessary to protect retail depositors who lack the information and power to monitor daily operations.

10. (C) A process where poor governance in one bank triggers systemic risk, impacting other banks through mutual lending and borrowing.
Contagion risk describes a situation where financial distress in one institution spreads throughout the banking sector. This often occurs because banks are interconnected through interbank lending and shared payment systems. Poor governance or failure in one entity can undermine public confidence in the entire industry, potentially leading to systemic instability and significant economic disruption if the crisis remains uncontained.

11. (D) (II), (I), (IV), (III)
Managing conflicts of interest requires a structured approach to maintain board integrity. The process begins with implementing comprehensive policies to identify potential issues. Once identified, these conflicts must be formally communicated to the board for evaluation. The board then assesses the materiality of the conflict and decides on appropriate mitigating measures. This sequence ensures transparency and protects the bank's interests.

12. (C) At least 60 minutes
Banks are required to foster a strong ethical culture by ensuring all staff understand the code of conduct. Employees must dedicate a minimum of sixty minutes annually to reviewing the conduct training manual before signing their adherence statement. This mandatory requirement ensures that personnel at all levels are regularly reminded of their professional responsibilities and the bank's core ethical values.

13. (A) The CCO is permitted to assume revenue generation responsibilities within the first line of defence to integrate compliance into operations.
To maintain the independence of the compliance function, the Chief Compliance Officer must not participate in revenue-generating activities. This official is responsible for identifying and mitigating enterprise-wide compliance risks. By reporting through the Audit Committee of the Board and holding a senior rank, the officer ensures that statutory requirements are prioritized without being compromised by commercial or operational targets.

14. (C) The ACB shall be made up of only Non-Executive Directors (NEDs) with a quorum requiring 2/3 to be independent directors.
The Audit Committee of the Board must be composed entirely of non-executive directors to ensure objective oversight of financial reporting and internal controls. A valid quorum for this committee requires that two-thirds of the members present be independent directors. This structural requirement safeguards the committee's independence from executive management and ensures that audits are conducted with the necessary skepticism.

15. (D) It serves as a key input to risk decisions by ensuring business performance is accurately reported, despite being part of the first line of defence.
The finance function operates within the first line of defence but provides vital support to the

NODIA

31. (C) Fit and proper principle - Ensuring board members have a clear understanding, qualification, and sound judgment.
The fit and proper principle is essential for ensuring that those in charge of banks are competent and ethical. It mandates that board members possess the necessary qualifications and demonstrate sound judgment in managing the bank's affairs. This principle safeguards the institution by ensuring that its leadership is capable of understanding complex risks and making decisions that protect stakeholders.

32. (B) Only (I), (II), (III), and (IV) are correct
The Audit Committee of the Board must rigorously examine financial statements before they are presented to the full board. This review includes assessing changes in accounting policies, evaluating major entries involving management judgment, and ensuring compliance with legal requirements. Furthermore, the committee must verify the transparency of related party transactions to prevent conflicts of interest and ensure reporting accuracy.

33. (B) P-3, Q-2, R-1, S-4
Specific executives are assigned distinct reporting lines to maintain independence. The Chief Risk Officer serves as the secretary to the risk committee, while the Chief Compliance Officer reports to the audit committee to ensure statutory adherence. The Head of Internal Audit is accountable directly to the board through the audit committee, and the vigilance head handles preventive and punitive measures.

34. (D) Assertion (A) is false, but Reason (R) is true.
In the banking industry, depositors provide the vast majority of operational funds. Despite this significant financial contribution, they do not participate in the day-to-day management or strategic decision-making of the institution. This lack of control, combined with high gearing ratios, makes depositors particularly vulnerable to mismanagement, necessitating strong regulatory oversight and robust corporate governance to protect their interests.

35. (B) Only (II) is correct
To safeguard the independence of the risk management function, strict rules govern the removal of the Chief Risk Officer. Any premature termination of this officer's employment cannot be done by a committee alone; it requires formal approval from the board of directors. Additionally, the bank must publicly disclose the specific reasons for such a removal to ensure transparency and accountability.

36. (A) No, because internal audit provides retrospective objective assurance, not preventive operational control.
Internal audit is fundamentally the third line of defence, providing retrospective assurance through independent evaluation. It does not possess the authority to sanction loans or manage daily operations, which are responsibilities of the business line. Therefore, internal audit cannot be held responsible for the initial approval of risky loans, as its role is to review and report on existing failures.

37. (C) P-4, Q-2, R-3, S-1
The Basel Committee's principles provide a roadmap for sound banking governance. Principle one focuses on the board's responsibility for strategic objectives and corporate values. Principle two addresses the qualifications of board members. Principle three emphasizes the need for clear lines of responsibility throughout the bank. Finally, principle four requires the board to ensure that senior management implements board policies correctly.

38. (A) Only (I), (II), and (III) are correct
The internal audit function provides the third line of defence by offering independent reviews of a bank's control environment. It must remain objective and avoid advisory roles that could lead to conflicts of interest. While specific expertise can be brought in through contractual experts, the function itself must not be entirely outsourced to an external audit firm.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Governance in banking is more critical than in other sectors because of the potential for systemic failure. Banks are highly interconnected, meaning that poor management in one institution can trigger a contagion effect

NODIA

across the entire financial system. Because banks hold public deposits and play a central role in the economy, their governance must satisfy regulators, depositors, and governments.

40. (B) RMCB meeting frequency - At least six times a year.
Board committees must meet frequently to ensure effective oversight of the bank's operations. The Risk Management Committee of the Board is also required to meet at least six times annually, matching the frequency requirement of the Audit Committee. This consistent frequency ensures that no more than sixty days elapse between meetings, allowing the committee to respond promptly to emerging financial and enterprise-wide risks.

41. (B) No, because the ACB must be made up of only Non-Executive Directors.
Corporate governance standards require the Audit Committee of the Board to be composed entirely of non-executive directors. This structural independence is necessary to ensure that the committee can objectively oversee the work of the executive management team and the internal audit function. Including the chief executive officer as a voting member would create a conflict of interest, compromising oversight.

42. (C) P-3, Q-4, R-2, S-1
Effective risk governance relies on clearly defined terms. Risk appetite describes the types of risk a bank proactively chooses to accept. Risk capacity refers to the maximum risk the bank can sustain. Conduct risk involves the potential for losses due to unethical behavior. Finally, tone at the top signifies the board's role in establishing a strong ethical culture and values.

43. (C) Only (I), (III), and (IV) are correct
The Chief Risk Officer holds several vital responsibilities within the risk governance framework. This officer participates in strategic and capital planning, ensuring that risk considerations are integrated into high-level decision-making. Additionally, the officer must communicate risk profiles clearly to the board and serve as the secretary to the Risk Management Committee, facilitating dialogue between management and the board.

44. (A) Only (I) and (II) are correct
Members of the Audit Committee of the Board must be financially literate to effectively review financial statements and audit reports. To maintain functional independence, the head of the internal audit function serves as the secretary to this committee. While the committee oversees many financial aspects, the appointment of the Chief Risk Officer is generally handled by the board.

45. (C) Ensuring the second line of defence has sufficient authority, stature, and independence.
The second line of defence, which includes the risk management function, must have sufficient authority and stature to challenge the first line business units. When risk officers are unable to influence or stop risky behaviors due to lack of authority, the governance framework has failed. Independence and the ability to report directly to the board are essential for effective oversight.

46. (B) P-2, Q-4, R-3, S-1
The three lines of defence model organizes risk management responsibilities across the bank. Business lines represent the first line, owning and managing the risks they incur. Risk management and compliance functions form the second line, providing independent monitoring and reporting. The internal audit function serves as the third line, offering independent assurance to the board on the overall framework.

47. (D) Assertion (A) is false, but Reason (R) is true.
Risk management functionaries should not have the authority to sanction or assume risk, as this belongs to the business line. Their role is to provide independent monitoring and assurance. This independence ensures that the board receives an objective assessment of the bank's risk profile without management filtering, allowing for a balanced view of the institution's exposure and control effectiveness.

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48. (B) Second line of defence - Internal audit providing independent review and objective assurance.
In the established framework of risk control, each line of defence has a specific role. The first line owns the risk, the second line monitors it through risk and compliance functions, and the third line provides independent assurance through internal audit. Claiming that internal audit belongs to the second line is incorrect, as its independence is maintained by acting separately.

49. (D) All (I), (II), (III), (IV), and (V) are correct
The board is responsible for overseeing senior management to ensure they act in the bank's best interest. This involves regular meetings, formal interactions with key functionaries, and setting appropriate performance standards. Boards must also assess the collective expertise of management and lead succession planning for the chief executive officer and other roles to ensure long-term stability and leadership continuity.

50. (A) Only (I) and (II) are correct
The Risk Management Committee of the Board must consist of non-executive directors and maintain a quorum with two-thirds independent directors. This ensures that risk oversight is not dominated by executive interests. The Chief Risk Officer reports to this committee and serves as its secretary. This committee operates within the second line of defence framework, focusing on risk policy oversight.

51. (D) No, because the chair of the ACB shall not chair any other committee of the Board.
To ensure specialized oversight and prevent the over-centralization of power, corporate governance rules place restrictions on committee leadership. Specifically, the individual who chairs the Audit Committee of the Board is prohibited from chairing any other board committee. This ensures that each committee receives dedicated focus and that the board maintains a healthy system of checks and balances across functions.

NODIA

52. (D) RMCB - Chaired by an independent director who is not a chair of any other committee.
Board committee composition is strictly regulated to ensure effective governance. The Risk Management Committee of the Board must be chaired by an independent director. To prevent potential conflicts of interest and ensure a focused approach to risk oversight, this chairperson cannot simultaneously serve as the head of any other committee. This requirement promotes independence and ensures dedicated committee leadership.

53. (C) Both (I) and (II) are correct
The compliance function is a key component of the second line of defence, responsible for managing compliance risk. This risk includes the potential for financial or reputational damage resulting from failure to adhere to laws and regulations. To remain effective, the function must be independent of business operations and focused on ensuring that the institution operates within all statutory frameworks.

54. (C) Assertion (A) is true, but Reason (R) is false.
The internal audit function must remain independent to provide objective assurance to the board. Entrusting internal auditors with advisory or operational roles would create a conflict of interest, as they would essentially be auditing their own decisions. Their primary responsibility is to evaluate the effectiveness of the first and second lines of defence without becoming involved in their execution.

55. (A) Only (I), (II), and (III) are correct
The vigilance function ensures institutional integrity through preventive, surveillance, and punitive domains. It utilizes advanced analytics to monitor employee-specific information, such as wealth updates, to detect irregularities. The Chief of Internal Vigilance maintains independence by reporting directly to the Audit Committee of the Board. This structure ensures that internal investigations and detection processes remain free from executive influence or interference.

56. (A) P-2, Q-3, R-4, S-1
Corporate governance is guided by principles that ensure ethical business conduct. Fairness

institution transitions its entire commercial portfolio to green loans.
(B) The point at which the income effect of credit risk mathematically exceeds the wealth effect on collateral.
(C) The threshold where historical data perfectly aligns with future climate projections for the global economy.
(D) A system threshold where change becomes abrupt and self-perpetuating even if the initial drivers abate.

Oct/Nov 2022

27. What is the most appropriate definition of ESG in the context of financial evaluation?
(A) Criteria (Environmental, Social, Governance) used in investment decisions or company operations.
(B) An economic framework strictly limiting the geographic expansion of commercial bank branches.
(C) A quantitative stress testing tool utilized exclusively for macro-prudential solvency evaluations.
(D) A sovereign regulatory requirement mandating 100% green loans in every commercial portfolio.

May/June 2005

28. What is the core concept underlying a "Circular Economy"?
(A) Minimizing waste by designing products to be repaired, reused, and recycled throughout their life cycle.
(B) Encouraging rapid consumption of natural resources to accelerate economic growth and industrial output.
(C) Issuing revolving funds continuously to carbon-intensive industries to ensure business continuity goals.
(D) Shifting public sentiment exclusively towards physical asset investments rather than financial securities.

Oct/Nov 2010

29. Which of the following is NOT a characteristic of a "Black Swan" event?
(A) They are unexpected and rare.
(B) Their impacts are catastrophic.
(C) Their probability can be precisely calculated using forward-looking climate scenarios and models.
(D) They can only be explained after the fact.

May/June 2021

30. Which of the following correctly identifies a characteristic of Green Swans compared to traditional Black Swans?
(A) Green Swans are highly predictable and their probability can be accurately mapped using historical data.
(B) Green Swans reflect normal distribution curves, mitigating the risk of cascading systemic failures.
(C) Green Swans are solely localized events with no potential to disrupt global financial systems.
(D) Green Swans involve complex chain reactions that could pose an existential threat to humanity.

Oct/Nov 2006

31. Identify the correct pair representing a component of the three lines of defence and its corresponding responsibility.
(A) First line – Undertake independent climate-related risk assessment and monitor overall compliance.
(B) Compliance function – Carry out regular audits of the internal control framework and data quality.
(C) Second line – Ensure adherence to rules and adopt escalation procedures to report material risks.
(D) Third line – Articulate the overarching strategic vision and define the institution's risk appetite.

May/June 2019

32. Consider the following statements describing the responsibilities of Senior Management regarding climate risk:
I Ensuring the development and implementation of the environmental risk management framework and policies.
II Reviewing regularly the effectiveness of the framework, tools, and metrics, and making appropriate revisions.
III Establishing an internal escalation process for managing material environmental risk exposures.
IV Updating the Board on material environmental risk issues in a timely manner.

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while respecting local regulations. This ensures that the bank's global operations do not create unforeseen risks.

65. (B) By both top-down board leadership and bottom-up management involvement.
Developing an effective Risk Appetite Statement requires a collaborative approach within the bank's governance framework. It should be driven by top-down leadership from the board, which sets the overall strategic direction, combined with bottom-up involvement from management, which understands operational realities. This ensures that the statement is both strategically aligned and practically applicable to the bank's various activities.

66. (C) Yes, because it involves a fraud of Rs. One Crore and above.
Regulatory guidelines establish specific thresholds for the oversight of fraudulent activities. Any fraud involving an amount of one crore rupees or more triggers a mandatory requirement for the Special Committee of the Board for Monitoring and Follow-up of Frauds to conduct a review. This process ensures that significant financial crimes are analyzed at the highest level to identify systemic failures and implement necessary improvements to internal controls.

67. (D) Put in place an approval process for all new processes and products by the compliance function.
Proactive compliance management requires that the compliance function is involved in the development of all new products and processes. By establishing a mandatory approval process, the Chief Compliance Officer can ensure that new initiatives meet all legal and regulatory standards before they are launched. This prevents the bank from inadvertently assuming excessive compliance risk or facing penalties after product implementation.

68. (A) No, because risk management functionaries should not have revenue generating responsibilities.
To maintain objectivity and independence, risk management functionaries are prohibited from having revenue-generating responsibilities. Assigning revenue targets to the Chief Risk Officer would create a fundamental conflict of interest, as the officer might prioritize profit over prudent risk mitigation. The role of the second line of defence is to provide unbiased monitoring, which is only possible when decoupled from profit targets.

NODIA

69. (B) The guarantee of confidentiality and protection from victimisation or unfair treatment.
The integrity of a whistle-blower system depends on the absolute protection of the person reporting the misconduct. A key principle of such policies is the guarantee of confidentiality and protection from any form of victimization or retaliation. When an employee's identity is revealed, leading to unfair treatment, this fundamental principle is violated, undermining the trust necessary for the system to function.

70. (B) No, premature removal of the CCO shall only be with prior board approval and must be disclosed publicly.
The removal of a Chief Compliance Officer is a significant event that requires board oversight to protect the independence of the compliance function. A chief executive officer cannot unilaterally dismiss this officer; the action must be approved by the board of directors. Furthermore, such a removal must be disclosed publicly, ensuring that the compliance function remains shielded from arbitrary pressure.

Oct/Nov 2015

13. Identify the incorrect statement concerning liquidity risk triggered by climate change.
(A) Banks never experience difficulties in liquidating assets impacted by weather events, as market liquidity remains consistently stable during natural disasters.
(B) Increased demand for liquidity in response to extreme weather events can directly impact banks' liquidity position through difficulties in raising funds.
(C) Natural disasters can cause widespread damage, leading to a surge in funds withdrawal and demand for emergency loans.
(D) Climate risk could lead to a breakdown in correlations between assets, undermining standard risk management assumptions.

May/June 2020

14. Which of the following is a correct statement regarding India's Nationally Determined Contribution (NDC)?
(A) India aims to achieve about 80% cumulative electric power installed capacity from non-fossil fuel energy.
(B) India aims to eliminate all greenhouse gas emissions from the agricultural sector by the year 2050.
(C) India aims to create an additional carbon sink of 2.5 to 3 billion tons of CO_2 equivalent by 2030.
(D) India plans to reduce the Emissions Intensity of its GDP by a total of 70% by the year 2030.

Oct/Nov 2005

15. What is the most appropriate reason for banks to adopt the Task Force on Climate-related Financial Disclosures (TCFD) framework?
(A) It guarantees an automatic upgrade in the credit ratings of the bank's corporate borrowers.
(B) It eliminates the need for establishing a three lines of defence internal control system.
(C) It restricts the bank from financing any sector that is vulnerable to acute physical risks.
(D) It provides a framework to disclose environmental risk management approaches to stakeholders.

May/June 2017

16. How is a "Green Swan" event formally described in the context of climate-related financial risk?
(A) A climate tail risk event with deep uncertainty and non-linearity, posing existential threats.
(B) A predictable climate event causing minimal disruption to the financial system and policy shifts.
(C) A conventional financial risk characterized by normal probability distributions and linear outcomes.
(D) A sudden technological breakthrough that eliminates systemic climate risks through global innovation.

Oct/Nov 2024

17. According to the definitions of environmentally sustainable projects for Green Finance, which of the following would NOT be considered an eligible project?
(A) The expansion of traditional deep-shaft coal mining operations to support industrial output.
(B) Waste management that includes recycling and efficient disposal.
(C) The construction of green buildings utilizing energy-efficient designs.
(D) Clean transportation networks that involve lower greenhouse gas emissions.

May/June 2010

18. As of early 2020, green bonds issued in India since January 1, 2018, constituted what percentage of all the bonds issued in the Indian financial market?
(A) 0.7%
(B) 5.4%
(C) 7.9%
(D) 33.0%

Oct/Nov 2011

19. Identify the incorrect statement regarding the issuance of Green Bonds in India.
(A) Most green bonds issued since 2015 have maturities ranging from five to ten years to support energy projects.
(B) Around 76% of the green bonds issued in India since 2015 were denominated in US

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price of carbon-intensive goods, mainly in energy and transport.
(C) To provide tax holidays to corporations extracting fossil fuels in remote offshore regions.
(D) To eliminate the wealth effect on pledged collateral held by commercial banks globally.

Oct/Nov 2017

7. Which of the following provides the most accurate definition of "net zero emissions"?
(A) Eliminating all greenhouse gas emissions completely from industrial and agricultural activities.
(B) Balancing the greenhouse gas emissions produced against those removed from the atmosphere.
(C) Transitioning energy production to renewable sources while implementing global carbon capture.
(D) Reducing global temperatures by 1.5°C compared to pre-industrial levels through taxation.

May/June 2006

8. Regarding the international regulatory framework for green finance, which of the following is a correct statement?
(A) The framework mandates that commercial banks must maintain 100% reserve requirements for fossil fuels.
(B) Directed lending, such as revolving funds for renewable energy, is a recognized regulatory category.
(C) Financial institutions are strictly prohibited from relying on the Task Force on Climate Disclosures.
(D) Micro-prudential regulations require central banks to issue green bonds for private manufacturing firms.

Oct/Nov 2008

9. Which of the following is NOT classified as a driver of transition risk?
(A) The introduction of climate-related mitigation policies, such as carbon taxes.
(B) The increasing frequency and severity of acute weather events like floods and wildfires.
(C) Technological advances contributing to the increased use of non-fossil fuels.
(D) Shifts in public sentiment where consumers reward environmentally resilient borrowers.

May/June 2024

10. Which of the following statements best differentiates weather from climate?
(A) Weather refers to long-term atmospheric patterns, whereas climate measures daily fluctuations in humidity.
(B) Weather represents changes over 30 years or more, whereas climate focuses on ocean acidification.
(C) Weather refers to short-term atmospheric conditions, whereas climate is the behavior over long periods.
(D) Weather evaluates the global greenhouse effect, whereas climate assesses local wind and pressure changes.

Oct/Nov 2021

11. Arrange the following key events related to the progress of green finance in India in chronological order from earliest to latest:
I. Formation of the Climate Change Finance Unit (CCFU) within the Ministry of Finance
II. Launch of the first phase of the Faster Adoption and Manufacturing of Hybrid and Electric Vehicles (FAME) scheme
III. Formulation of the National Action Plan on Climate Change (NAPCC)
IV. SEBI issues guidelines for green bond issuance specifying disclosure requirements
(A) I, III, IV, II
(B) III, II, I, IV
(C) II, I, III, IV
(D) III, I, II, IV

May/June 2013

12. What is the primary goal of the Paris Agreement regarding global warming?
(A) To ensure global temperatures decrease by exactly 4°C by the end of this century.
(B) To maintain global temperatures at 1850 levels without any further increase whatsoever.
(C) To limit global warming to well below 2°C, and ideally 1.5°C, above pre-industrial levels.
(D) To reduce average sea temperatures to pre-1900 levels through global carbon taxation efforts.

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involves treating all stakeholders with equal consideration. Transparency fosters confidence through openness. Integrity requires straightforward dealing and presenting a balanced view of affairs. Accountability ensures that the purpose and results of a company's activities are clearly explained to those with a legitimate interest in the institution's conduct.

57. (A) The Retail Lending Department (Business Line)
Under the three lines of defence model, the business line—such as a retail lending department—is the primary owner of the risks it creates. This department is responsible for following established credit checks and risk limits during its daily operations. When these controls are bypassed to meet revenue targets, the initial failure and accountability lie with that business unit.

58. (A) Only (I) is correct
The finance function, although part of the first line of defence, is essential for accurate risk management. It ensures that financial performance is correctly recognized, providing necessary data for risk decisions. Accurate reporting allows the second line and the board to understand the bank's true position. This function's role in reporting is a critical input for maintaining financial integrity.

59. (A) Only (I), (II), (IV), and (V) are correct
A robust whistle-blower policy must include clear procedures for handling reports of misconduct. This includes guaranteeing confidentiality, confirming receipt of reports, and establishing clear timelines for action. Critically, there must be a mechanism for escalating concerns to the chair of the audit committee or the board if necessary. These steps ensure that reports are taken seriously and informants protected.

60. (D) All (I), (II), and (III) are correct
The board plays a fundamental role in establishing a bank's culture and values. This involves mandating annual conduct training for all employees and ensuring that adherence to ethical values is a part of performance appraisals. Additionally, the board must define the bank's risk appetite, ensuring it is aligned with strategic plans to foster an environment where ethics are prioritized.

61. (C) The Risk Management Committee of the Board (RMCB)
To ensure the independence and authority of the risk management function, the Chief Risk Officer must have a clear and direct reporting line. This officer reports primarily to the Risk Management Committee of the Board. This structure prevents executive management from filtering risk information and ensures that the board receives an unvarnished view of the institution's enterprise-wide risk profile.

62. (A) Identify the systemic lacunae that facilitated the fraud and put in place measures to plug the same.
When a significant fraud occurs, the Special Committee of the Board for Monitoring and Follow-up of Frauds must look beyond the immediate loss to identify broader systemic issues. The committee is responsible for uncovering the lacunae or weaknesses in the bank's processes that allowed the fraud to happen. By implementing measures to plug these gaps, the committee helps prevent similar occurrences and strengthens internal controls.

63. (C) Two-thirds (2/3) of the members must be independent directors.
The quorum requirements for key board committees like the Audit Committee and the Risk Management Committee are designed to ensure independent oversight. For a meeting to be validly constituted, at least two-thirds of the members present must be independent directors. This high threshold ensures that independent voices have a dominant say in the committee's deliberations regarding financial and risk controls.

64. (C) The compliance function must be consistent with host country requirements, with oversight by the CCO.
When operating internationally, banks must comply with the legal requirements of both their home and host countries. The compliance function is responsible for ensuring that foreign branches adhere to local statutes. The Chief Compliance Officer oversees this process to maintain consistency across the organization

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dollars for investors.

(C) The World Bank has issued green bonds towards several high-impact sustainable projects in India periodically.

(D) Green bonds are issued only by sovereign entities, preventing private corporates from using the instrument.

May/June 2009

20. Which of the following statements correctly identifies how market risk emerges from climate risk?

(A) Climate risks reveal new information about economic conditions, leading to price shocks and volatility.

(B) Extreme weather events directly cause a surge in deposit withdrawals, leading to central bank insolvency.

(C) Changes in borrowing costs due to technology advances enhance the correlation between unrelated assets.

(D) Repricing of financial assets guarantees higher profitability for all borrowers transitioning energy use.

Oct/Nov 2019

21. Arrange the following steps of Climate Scenario Analysis in their correct chronological order:

I. Assess counterparty and/or sector sensitivities to those risks

II. Identify physical and transition risk scenarios

III. Extrapolate the impacts of those sensitivities to calculate an aggregate measure of exposure

IV. Link the impacts of scenarios to financial risks

(A) I, II, IV, III

(B) II, I, IV, III

(C) II, IV, I, III

(D) IV, II, III, I

May/June 2025

22. Under India's Nationally Determined Contribution (NDC), what is the targeted reduction for the Emissions Intensity of its GDP?

(A) 33% by 2025, from 2005 level.

(B) 40% by 2030, from 2015 level.

(C) 45% by 2030, from 2005 level.

(D) 50% by 2070, from 2010 level.

Oct/Nov 2007

23. In the context of credit risk driven by physical and transition climate risks, how does the "wealth effect" fundamentally differ from the "income effect"?

(A) The wealth effect impacts a borrower's ability to service debt, whereas the income effect impacts infrastructure.

(B) The wealth effect refers to the financial gains from green bonds, whereas the income effect refers to subsidies.

(C) The wealth effect downgrades sovereign credit ratings, whereas the income effect triggers downward price shocks.

(D) The wealth effect reduces recoverable collateral value, whereas the income effect reduces repayment capacity.

May/June 2014

24. Among the risk measurement processes currently being applied by banks and supervisors to evaluate climate risk, which of the following is NOT included in the recognized conventional practices?

(A) Scenario analysis

(B) Sensitivity analysis

(C) Natural capital analysis

(D) Standardized backward-looking linear amortization scaling

Oct/Nov 2016

25. Identify the incorrect statement regarding physical risk drivers.

(A) Physical risk drivers can be categorized as acute risks, which are related to extreme weather events.

(B) Indirect effects of climate change, such as the loss of ecosystem services, inevitably result in lower levels of migration and reduced humanitarian crises.

(C) Chronic physical risks refer to longer-term gradual shifts of the climate, such as rising average temperatures and ocean acidification.

(D) The economic and financial risks associated with physical risks reflect damages to property and infrastructure.

May/June 2018

26. What is the definition of a "Tipping Point" in the context of climate risk?

(A) The specific date when a financial

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CHAPTER 22
Climate Risk and Sustainable Finance

Oct/Nov 2023

1. Under the Priority Sector Lending (PSL) scheme in India, what is the maximum loan eligibility for firms in the renewable energy sector?
(A) ₹10 lakh
(B) ₹15 crore
(C) ₹25 crore
(D) ₹30 crore

May/June 2011

2. Which of the following statements about Government of India incentives for green finance is incorrect?
(A) Beneficiaries can avail themselves of a generation-based incentive of ₹2 per unit if generation exceeds 1100 kWh – 1500 kWh per year.
(B) The FAME scheme aims to reduce the up-front purchase price of all hybrid and electric vehicles and develop charging infrastructures.
(C) The Government of India offers 100% of the installation cost of rooftop solar panels as a subsidy to the commercial sector in all states.
(D) The State Bank of India introduced a 'green car loans' scheme for electric vehicles featuring a 20 basis points lower interest rate compared to existing car loans.

Oct/Nov 2012

3. Which of the following defines the concept of "Climate Value-at-Risk" (VaR)?
(A) A backward-looking metric used to assess historical losses incurred by a bank due to physical climate risks.
(B) A subjective rating system that assigns a qualitative score to exposures according to a borrower's carbon.
(C) A forward-looking metric quantifying climate impacts on asset values over a specific time and probability.
(D) An operational metric determining the likelihood of physical damage to data centers due to acute weather.

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May/June 2015

4. What is the most appropriate reason why the 'tone at the top' plays a key role in shaping a bank's risk culture regarding climate risk?
(A) It dictates the exact numerical parameters used in climate Value-at-Risk calculations.
(B) It ensures that the first line of defence is completely exempt from identifying potential risks.
(C) It helps define the roles of senior management in managing climate and environmental risks.
(D) It automatically replaces the need for an internal audit mechanism within the organization.

Oct/Nov 2013

5. Which of the following accurately describes "stranded assets" resulting from transition risks?
(A) Assets pledged as collateral that are destroyed by acute extreme weather events such as floods.
(B) Carbon-intensive assets or fossil fuel reserves that lose economic value and become uneconomical.
(C) Data centers owned by financial institutions that lose power due to severe storms and hurricanes.
(D) Natural capital assets like clean air and forests that suffer severe degradation from pollution.

May/June 2008

6. What is the most appropriate purpose of implementing Carbon Taxation?
(A) To generate a revolving fund exclusively for underwriting traditional internal combustion engine vehicles.
(B) To reduce emissions by increasing the

V Formulating the overarching risk appetite framework by exclusively focusing on short-term financial interests.

Which of the above statements are correct?

(A) I, II, III, and V
(B) I, II, III, and IV
(C) II, III, IV, and V
(D) I, III, IV, and V

Oct/Nov 2014

33. Match the risk measurement tools in List I with their defining procedures in List II.

List I: (Measurement Tool)

P. Climate risk scores
Q. Stress testing
R. Sensitivity analysis
S. Natural capital analysis

List II: (Procedure)

1. Identifies a portfolio's dependencies on clean air, water, and forests
2. Evaluates the effect of altering a specific variable across multiple scenario runs
3. Evaluates a financial institution's near-term resiliency to severe but plausible economic shocks
4. Combines a risk classification scheme with grading criteria to assign a quality score to exposures

(A) P-2, Q-1, R-4, S-3
(B) P-4, Q-3, R-2, S-1
(C) P-1, Q-4, R-3, S-2
(D) P-3, Q-2, R-1, S-4

May/June 2012

34. Given below are two statements, one is labelled as Assertion (A) and the other is labelled as Reason (R).

Assertion (A): Climate change is often described as a "green swan" event rather than a typical "black swan" event.

Reason (R): Climate catastrophes have a high degree of certainty that they will materialize, pose an existential threat to humanity, and involve a higher order of complexity.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2025

35. Consider the following statements regarding the progress of Green Finance in India:

I A survey on Climate Risk and Sustainable Finance released in 2022 covered only public sector banks in India.
II As at end-March 2020, the aggregate outstanding bank credit to the non-conventional energy sector was around ₹36,543 crore.

Which of the given statements is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2007

36. Due to the devastation of the farmland from a cyclone, the farming corporates financed by 'Oceanic Bank' are completely unable to generate their usual harvest revenues for the current financial year. Their inability to generate cash flow severely impairs their capacity to repay debt to the bank. This consequence represents:

(A) The income effect
(B) Reputational risk
(C) Liquidity risk
(D) The wealth effect

Oct/Nov 2018

37. Match the specific targets of India's Nationally Determined Contribution (NDC) in List I with their respective descriptions in List II.

List I: (Target)

P. Emissions Intensity of GDP
Q. Cumulative electric power installed capacity
R. Additional carbon sink
S. Long-term net zero goal

List II: (Description)

1. 2070
2. Achieve about 50% from non-fossil fuel-based energy resources by 2030
3. 2.5 to 3 billion tons of CO2 equivalent through forest cover
4. Reduce by 45% by 2030, from 2005 level

(A) P-4, Q-2, R-3, S-1

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(B) P-2, Q-3, R-1, S-4
(C) P-1, Q-4, R-2, S-3
(D) P-3, Q-1, R-4, S-2

May/June 2023

38. Consider the following statements identifying drivers and consequences of Transition Risks:

I Climate-related mitigation policies could include the introduction of subsidies to encourage energy-efficient processes.

II Technological advances can contribute to energy transition by aggressively increasing the use of fossil fuels.

III Transitions to lower-carbon economies may create "stranded assets" that can no longer earn an economic return.

IV Shifts in public sentiment can influence financial markets to reward borrowers resilient to the transition away from a carbon-intensive economy.

Which of the above statements are correct?
(A) I, II, and III
(B) II, III, and IV
(C) I, III, and IV
(D) I, II, III, and IV

Oct/Nov 2009

39. Given below are two statements, one is labelled as Assertion (A) and the other is labelled as Reason (R).
Assertion (A): Historical data and traditional backward-looking risk assessment methods are unlikely to adequately capture future climate impact.
Reason (R): The exact timing, outcome, and future pathways of physical and transition risks remain highly certain and are unevenly distributed among countries.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2016

40. Identify the incorrect pair linking a financial risk to its climate risk transmission mechanism.
(A) Income Effect – A borrower's impaired ability to generate cash flows and service debt due to damaged infrastructure.
(B) Wealth Effect – A reduction in the fully recoverable value of a loan due to damaged physical collateral.
(C) Liquidity Risk – Exacerbated stress caused by a surge in funds withdrawal and high demand for emergency loans following a severe natural disaster.
(D) Reputational Risk – Disruption in the bank's daily business continuity resulting from physical damage to its own leased data centers.

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Oct/Nov 2020

41. As consumer preferences shift rapidly towards electric vehicles, 'AutoDrive Corp' realizes its massive diesel-engine manufacturing plants are becoming economically unviable. Because these plants are no longer able to earn an economic return in a lower-carbon economy, they are best described as:
(A) Natural capital assets
(B) Stranded assets
(C) Green bond collaterals
(D) Sovereign transition liabilities

May/June 2022

42. Match the international regulatory frameworks for green finance in List I with their respective examples in List II.
List I: (Regulatory Category)
P. First Category
Q. Second Category
R. Third Category
S. Fourth Category
List II: (Example)
1. Establishment of green financial institutions like the UK Green Investment Bank
2. Sustainability disclosure by financial and non-financial companies reporting ESG exposures
3. Directed and concessional lending, such as revolving funds for renewable energy
4. Micro and macro-prudential regulations, such as differential reserve requirements
(A) P-1, Q-4, R-2, S-3
(B) P-3, Q-1, R-4, S-2
(C) P-2, Q-3, R-4, S-1

(D) P-4, Q-2, R-1, S-3

Oct/Nov 2023

43. Consider the following statements outlining the responsibilities of the Board of Directors under the Climate Risk Management Framework:

I Overseeing the development and implementation of the environment and climate-related risk strategy of the bank.

II Ensuring that systems and controls are in place to support the implementation of the strategy.

III Fostering a risk culture that incorporates climate-related and environmental considerations into the decision-making process.

IV Establishing the daily internal escalation process to manage material operational exceptions personally.

Which of the above statements are correct?

(A) I, II, and IV
(B) II, III, and IV
(C) I, II, and III
(D) I, III, and IV

May/June 2011

44. Consider the following statements regarding the unique characteristics of climate change as a financial risk:

I Its impact is far-reaching in terms of breadth, magnitude, and relevance across multiple geographies.

II The exact timing, outcome, and future pathways of both physical and transition risks remain highly certain and predictable.

III Climate risk drivers are likely subject to non-linearities, such as tipping points, that exacerbate uncertainty.

Which of the above statements are correct?

(A) I and II
(B) II and III
(C) I and III
(D) I, II, and III

Oct/Nov 2012

45. Following a severe category-5 cyclone in the coastal region financed by 'Oceanic Bank', specialized agricultural machinery pledged as security by several large farming corporates is entirely destroyed. This destruction significantly reduces the recoverable value of the bank's pledged assets. Under credit risk transmission, this phenomenon is specifically identified as:

(A) The income effect
(B) The stranded asset effect
(C) The wealth effect
(D) The green swan effect

May/June 2015

46. Match the specific financial risk categories in List I with the corresponding climate-related impacts in List II.

List I: (Risk Category)

P. Credit Risk
Q. Market Risk
R. Liquidity Risk
S. Operational Risk

List II: (Impact)

1. Abrupt repricing of financial assets and downward price shocks
2. Disruption in business continuity due to damage to physical property and data centers
3. Inability of a borrower to service debt due to damaged inventory or income reduction
4. Surge in funds withdrawal and demand for emergency loans post-disaster

(A) P-2, Q-4, R-1, S-3
(B) P-3, Q-1, R-4, S-2
(C) P-4, Q-3, R-2, S-1
(D) P-1, Q-2, R-3, S-4

Oct/Nov 2013

47. Given below are two statements, one is labelled as Assertion (A) and the other is labelled as Reason (R).

Assertion (A): Banks may be exposed to high reputational risk from financing corporate customers that carry on business activities with a negative environmental impact.

Reason (R): The negative perception of such financing activities allows banks to establish robust, long-lasting business relationships with progressive ESG investors.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.

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(D) Assertion (A) is false, but Reason (R) is true.

May/June 2008

48. Identify the incorrect statement regarding climate-related risks.
(A) Acute Physical Risk – Extreme weather events such as heatwaves, storms, and wildfires.
(B) Acute Physical Risk – Shifts in consumer sentiment and investor behaviour leading to stranded assets.
(C) Chronic Physical Risk – Longer-term gradual shifts such as changes in precipitation and rising sea levels.
(D) Indirect effect of climate change – Loss of ecosystem services leading to increased risk of humanitarian crises.

Oct/Nov 2017

49. Consider the following statements regarding the policies and processes a bank should implement under the Climate Risk Management Framework:
I Clear articulation of the roles and responsibilities of business lines and functions in managing environmental risk.
II Identification and assessment of environmental risk on a customer and portfolio basis.
III Implementation of effective risk management practices and internal controls.
IV Effective monitoring of environmental risk and timely update to the bank's Board and senior management.
V Completely outsourcing all environmental risk assessments to external third-party rating agencies without any internal review mechanisms.
Which of the above statements are correct?
(A) I, II, III, and IV
(B) I, III, IV, and V
(C) II, III, IV, and V
(D) I, II, IV, and V

May/June 2006

50. Consider the following statements regarding general awareness and green finance:
I There is abundant and highly comprehensive data from conventional sources for assessing the awareness regarding green finance.
II Google Trends can be a tool for understanding the pattern of searches regarding sustainable development over time and space.
III Green financing explicitly aims to decrease the level of financial flows from the private sector to sustainable development priorities.
Which of the above statements are correct?
(A) Only I
(B) Only II
(C) I and III
(D) II and III

Oct/Nov 2008

51. 'AutoDrive Corp' is a legacy automobile manufacturer heavily reliant on internal combustion engines. To meet its international net zero commitments, the government suddenly announces a stringent carbon taxation policy. For AutoDrive Corp, this sudden policy shift represents which specific category of risk driver?
(A) Chronic physical risk
(B) Operational compliance risk
(C) Acute physical risk
(D) Mitigation policy driver (Transition risk)

May/June 2024

52. Identify the correct pair representing a climate risk category and its appropriate example.
(A) Chronic physical risk – Sudden, unexpected flash floods resulting in immediate facility closures.
(B) Technological advances (Transition risk) – Degradation of marine ecology resulting in water shortages.
(C) Acute physical risk – Rising average global temperatures and gradual ocean acidification.
(D) Mitigation policy – Subsidies to encourage the use of energy-efficient goods and processes.

Oct/Nov 2021

53. Consider the following statements regarding the Climate Risk Management Framework:
I The Board of Directors is strictly responsible for establishing the internal escalation process for managing day-to-day material environmental risk exposures.

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II Senior management is responsible for allocating adequate resources with appropriate expertise to manage the bank's environmental risk.

Which of the given statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2013

54. Given below are two statements, one is labelled as Assertion (A) and the other is labelled as Reason (R).

Assertion (A): Extreme weather events can exacerbate liquidity stresses and indirectly impact banks' ability to maintain a stable liquidity position.

Reason (R): Natural disasters can cause widespread damage to physical property, leading to a surge in funds withdrawal and higher demand for emergency loans.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2015

55. Consider the following statements regarding the sequential steps involved in natural capital analysis:

I Identifying relevant geographies, sectors, borrowers, and/or assets.
II Identifying relevant natural capital assets such as water, clean air, and forests.
III Identifying potential natural disruptions.
IV Calculating Climate Value-at-Risk using traditional macroeconomic variables instead of geographies at risk.

Which of the above statements are correct?
(A) I, II, and III
(B) II, III, and IV
(C) I, III, and IV
(D) I, II, and IV

May/June 2020

56. Match the key green finance concepts in List I with their corresponding descriptions in List II.

List I: (Green Finance Concept)
P. Green Finance
Q. Green Loan
R. Green Bond
S. Carbon Taxation

List II: (Description)
1. A tax levied on the carbon content of some goods and services to reduce emissions
2. Bonds issued with the aim that proceeds are utilised for environmentally sustainable projects
3. Financial arrangements specific to the use for environmentally sustainable projects
4. A loan available specifically for green eligible sustainable projects

(A) P-3, Q-4, R-2, S-1
(B) P-2, Q-3, R-1, S-4
(C) P-4, Q-1, R-3, S-2
(D) P-1, Q-2, R-4, S-3

Oct/Nov 2005

57. 'Oceanic Bank' has a significant loan portfolio concentrated in coastal agricultural regions. Recently, scientists warned of a gradual but persistent rise in sea levels in the region, threatening to submerge low-lying farms over the next few decades. This long-term geographical vulnerability is best classified as which type of climate risk driver?
(A) Chronic physical risk
(B) Acute physical risk
(C) Mitigation transition risk
(D) Technological transition risk

May/June 2017

58. Consider the following statements regarding the global climate situation and international agreements:

I Scientists estimate that global temperatures have risen by around 1°C since 1850.
II The primary goal of the Paris Agreement is to limit global warming to a maximum of exactly 3°C compared to pre-industrial levels.

Which of the given statements is/are correct?
(A) Only (I)
(B) Only (II)

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transparently communicate their environmental risk management strategies to investors, regulators, and other stakeholders. This improves market transparency, helps in the accurate pricing of climate risks, and supports better-informed capital allocation decisions across the industry.

16. (A) A climate tail risk event with deep uncertainty and non-linearity, posing existential threats.
A Green Swan event is defined as a climate-related catastrophe that lies outside the realm of normal expectations and carries the potential for systemic financial disruption. These events are characterized by deep uncertainty, non-linear impacts, and the possibility of posing existential threats to humanity. Unlike traditional financial crises, they involve complex chain reactions that can fundamentally destabilize global economic and social systems.

17. (A) The expansion of traditional deep-shaft coal mining operations to support industrial output.
Green finance is specifically designed to support projects that contribute to environmental sustainability and climate mitigation. Eligible activities include waste management, recycling, green building construction, and clean transportation initiatives. Traditional fossil fuel projects, such as the expansion of deep-shaft coal mining, are excluded from green financing as they contribute to increased carbon emissions and run counter to global climate transition goals.

18. (A) 0.7%
Although green finance is a growing sector in India, green bonds still represent a very small fraction of the total bond market. By early two thousand twenty, data indicated that green bonds issued since the start of two thousand eighteen accounted for only zero point seven percent of all bonds issued in the country. This highlights the significant potential for future expansion.

19. (D) Green bonds are issued only by sovereign entities, preventing private corporates from using the instrument.
Green bonds in India are not limited to sovereign issuances; they are frequently used by private corporations to fund sustainable projects. Since two thousand fifteen, a significant portion of these bonds has been denominated in US dollars to attract international investors. These instruments typically have maturities of five to ten years and are utilized for renewable energy and other eco-friendly infrastructure developments.

20. (A) Climate risks reveal new information about economic conditions, leading to price shocks and volatility.
Market risk arises from climate change when new information regarding environmental hazards or policy shifts leads to the abrupt repricing of financial assets. Such developments can trigger sudden price shocks and increased volatility in equity, bond, and commodity markets. As investors adjust their expectations for future returns based on climate-related vulnerabilities, the resulting market movements can impact the value of bank portfolios.

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21. (C) II, IV, I, III
Climate Scenario Analysis begins by identifying relevant physical and transition risk scenarios. Following this, the impacts of these scenarios are linked to specific financial risks. Next, the bank assesses the sensitivity of its counterparties or specific sectors to these identified risks. Finally, the results are extrapolated to calculate an aggregate measure of exposure across the entire lending or investment portfolio.

22. (C) 45% by 2030, from 2005 level.
India has updated its Nationally Determined Contribution to reflect more ambitious climate goals. A key target is to reduce the emissions intensity of its Gross Domestic Product by forty-five percent by the year two thousand thirty, compared to the base levels recorded in two thousand five. This commitment demonstrates India's resolve to decouple its economic growth from greenhouse gas emissions over time.

Hybrid and Electric Vehicles.
(D) Fiscal Assistance for Mitigating Emissions in industrial sectors.

Oct/Nov 2007

65. The risk management team at 'Global Finance Bank' wishes to evaluate the specific impact of a newly proposed carbon tax on its industrial lending portfolio. They decide to run multiple simulations where only the single parameter of 'carbon price' is altered to observe the resulting range of economic outcomes. This specific measurement technique is known as:
(A) Climate risk scoring
(B) Sensitivity analysis
(C) Natural capital analysis
(D) Micro-prudential stress testing

May/June 2014

66. The Board of Directors of 'GreenTrust Bank' is formalizing its Climate Risk Management Framework using a three lines of defence model. They assign the relationship managers in the corporate lending division the task of conducting the initial climate-related risk assessments for all new clients. In this framework, the relationship managers represent:
(A) The second line of defence
(B) The third line of defence
(C) The Board-level assurance line
(D) The first line of defence

Oct/Nov 2016

67. 'EcoBank' is actively expanding its sustainable finance portfolio. It sanctions a ₹25 crore loan to a corporate client strictly for setting up a small renewable energy solar park. EcoBank classifies this loan under the Priority Sector Lending (PSL) scheme because, under the scheme rules in India, firms in the renewable energy sector are eligible for loans up to:
(A) ₹10 lakh
(B) ₹15 crore
(C) ₹30 crore
(D) ₹50 crore

May/June 2018

68. To further gauge the long-term impact of climate change on its balance sheet, 'Global Finance Bank' implements a forward-looking, portfolio-level metric. This metric quantifies the financial impact on asset values over a 10-year horizon at a 95% probability under a 2°C warming scenario. This methodology utilizes:
(A) Climate Value-at-Risk (VaR)
(B) Backward-looking credit scoring
(C) Heatmap quality grading
(D) Macro-prudential capital targeting

Oct/Nov 2022

69. 'GreenTrust Bank' appoints an independent internal audit group to carry out regular, comprehensive reviews of the overall internal control framework and evaluate the quality of the underlying climate risk data utilized by the bank. This audit group operates as:
(A) The first line of defence
(B) The third line of defence
(C) The second line of defence
(D) The frontline strategic planning unit

May/June 2005

70. 'EcoBank' decides to diversify its investments by purchasing debt securities issued by an alliance. The proceeds of these specific debt securities are legally ring-fenced and utilized entirely for financing environmentally sustainable forestry projects. These securities are officially classified in the financial market as:
(A) Carbon tax credits
(B) Green bonds
(C) Direct revolving funds
(D) Eco-innovation derivatives

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(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2024

59. Consider the following measures that banks may carry out to mitigate or refrain from climate-related risks:

I Applying tenor limitations to customers in sectors highly vulnerable to emerging climate risk.
II Enforcing a lower loan-to-value limit for customers with real estate collateral that does not meet minimum sustainability criteria.
III Requiring customers whose production depends directly on weather conditions to take out insurance against extreme weather events.
IV Requiring customers in CO2 intensive industries to have a sustainable energy transition strategy.
V Immediately terminating all existing and future credit lines to any corporate entity that has non-zero carbon emissions.

Which of the above statements are correct?
(A) I, II, IV, and V
(B) I, II, III, and IV
(C) II, III, IV, and V
(D) I, III, IV, and V

May/June 2010

60. Consider the following statements illustrating the impact of climate risk on credit risk:

I Damage to physical capital reduces the value of assets and consequently a counterparty's wealth, triggering a wealth effect.
II Damaged physical capital generates less income, negatively impacting the cash flows and creating an income effect.
III Chronic physical risks, such as rising sea levels, are excluded from having any potential negative impact on commercial credit exposures.

Which of the above statements are correct?
(A) I and II
(B) II and III
(C) I and III
(D) I, II, and III

Oct/Nov 2011

61. A central bank mandates 'Global Finance Bank' to evaluate its near-term resiliency and capital adequacy target against a sudden, severe but plausible systemic economic shock triggered by an abrupt global transition away from fossil fuels. The most appropriate evaluation tool for this specific requirement is:
(A) Natural capital asset dependency mapping
(B) Frontline operational monitoring
(C) Climate stress testing
(D) Circular economy lifecycle analysis

May/June 2009

62. 'GreenTrust Bank' mandates its internal compliance team to independently reassess the initial climate risk evaluations conducted by the relationship managers, ensuring strict adherence to applicable environmental regulations. This compliance team functions as:
(A) The second line of defence
(B) The first line of defence
(C) The third line of defence
(D) The external audit function

Oct/Nov 2019

63. As external agencies assess the impact of the carbon tax and shifting sentiments on 'AutoDrive Corp's profitability, they downgrade the company's credit rating. For the commercial bank that extended large credit lines to AutoDrive Corp, this downgrade primarily reflects an increase in:
(A) Liquidity risk due to deposit flight
(B) Operational risk due to failed internal processes
(C) Credit risk arising from transition risk
(D) Liability risk from shareholder lawsuits

May/June 2025

64. 'EcoBank' launches a retail 'Green Car Loan' scheme offering a lower interest rate for electric vehicles. This retail scheme aligns with the government's FAME scheme to develop charging infrastructure. What does the acronym FAME stand for?
(A) Financial Allocation for Manufacturing Electronics and components.
(B) Funding for Alternative Machinery and Equipment for green growth.
(C) Faster Adoption and Manufacturing of

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8. (B) Directed lending, such as revolving funds for renewable energy, is a recognized regulatory category.
International regulatory frameworks for green finance often include specific categories to promote sustainability. Directed lending, which involves providing concessional loans or establishing revolving funds for renewable energy projects, is a recognized method for central banks to support environmental goals. These measures help channel capital toward green initiatives by offering more favorable terms compared to traditional high-carbon industrial financing options.

9. (B) The increasing frequency and severity of acute weather events like floods and wildfires.
Transition risks arise from the process of adjusting toward a low-carbon economy, involving policy changes, technological breakthroughs, and shifts in market sentiment. In contrast, the increasing frequency and severity of acute weather events like floods, droughts, and wildfires are categorized as physical risks. These events cause direct damage to physical assets and infrastructure, impacting financial stability through different transmission channels.

10. (C) Weather refers to short-term atmospheric conditions, whereas climate is the behavior over long periods.
Distinguishing between weather and climate is essential for understanding environmental risks. Weather describes the short-term state of the atmosphere, including daily changes in temperature, precipitation, and wind. Climate, however, represents the long-term average of these weather patterns, typically measured over a period of thirty years or more. Understanding these timescales helps financial institutions assess both immediate shocks and gradual trends.

11. (D) III, I, II, IV
India's green finance journey began with the National Action Plan on Climate Change in two thousand eight. This was followed by the creation of the Climate Change Finance Unit in two thousand eleven. The first phase of the FAME scheme was launched in two thousand fifteen, and SEBI issued guidelines for green bond issuance in two thousand seventeen.

12. (C) To limit global warming to well below 2°C, and ideally 1.5°C, above pre-industrial levels.
The Paris Agreement is a landmark international treaty aimed at addressing the global climate crisis. Its central objective is to limit the increase in global average temperature to well below two degrees Celsius above pre-industrial levels. Furthermore, the agreement emphasizes pursuing efforts to further restrict the temperature rise to one point five degrees Celsius to significantly reduce climate-related risks.

13. (A) Banks never experience difficulties in liquidating assets impacted by weather events, as market liquidity remains consistently stable during natural disasters.
Liquidity risk is significantly affected by climate change as extreme weather events can cause sudden, large-scale financial disruptions. Natural disasters often trigger a surge in deposit withdrawals and a simultaneous spike in demand for emergency credit. Such events can severely impair a bank's ability to maintain stable funding and liquidate assets, contrary to the assumption that market liquidity remains unaffected.

14. (C) India aims to create an additional carbon sink of 2.5 to 3 billion tons of CO2 equivalent by 2030.
As part of its international climate commitments, India has established Nationally Determined Contributions to mitigate greenhouse gas emissions. One major target involves the creation of an additional carbon sink of two point five to three billion tons of carbon dioxide equivalent. This objective is to be achieved through significant increases in forest and tree cover by the year two thousand thirty.

15. (D) It provides a framework to disclose environmental risk management approaches to stakeholders.
The Task Force on Climate-related Financial Disclosures provides a standardized global framework for organizations to report their climate-related risks and opportunities. By adopting these recommendations, banks can

NODIA

ANSWERS

1. (D) ₹30 crore
Priority Sector Lending guidelines set by the Reserve Bank of India define specific eligibility limits for various green sectors. For the renewable energy sector, bank loans up to a limit of thirty crore rupees to borrowers for purposes like solar-based power generators, biomass plants, and wind mills are eligible under the priority sector category to encourage sustainable power.

2. (C) The Government of India offers 100% of the installation cost of rooftop solar panels as a subsidy to the commercial sector in all states.
The Government of India provides various incentives for green energy, but the subsidy for rooftop solar panels is typically capped at around forty percent for residential sectors, rather than one hundred percent for the commercial sector. Commercial entities generally benefit from accelerated depreciation and other tax-related incentives rather than a full installation cost subsidy from the state.

3. (C) A forward-looking metric quantifying climate impacts on asset values over a specific time and probability.
Climate Value-at-Risk serves as a sophisticated forward-looking financial metric designed to quantify the potential impact of climate change on asset values. It estimates potential losses over a specific time horizon and at a given probability level. This tool helps financial institutions incorporate long-term environmental uncertainties into their current risk management frameworks by modeling various future climate pathways.

4. (C) It helps define the roles of senior management in managing climate and environmental risks.
The leadership commitment within a financial institution establishes the fundamental risk culture necessary for addressing environmental challenges. By setting a clear tone at the top, the board and senior management define specific roles and responsibilities for managing climate risks. This strategic direction ensures that environmental considerations are integrated across all business lines, fostering accountability and long-term organizational resilience.

5. (B) Carbon-intensive assets or fossil fuel reserves that lose economic value and become uneconomical.
Stranded assets are investments that suffer from unanticipated or premature write-downs, devaluations, or conversion to liabilities due to the transition toward a low-carbon economy. This often happens to fossil fuel reserves or carbon-intensive infrastructure as new regulations, carbon taxes, or technological shifts make these assets economically unviable. They represent a significant financial risk for banks with heavy industrial exposures.

6. (B) To reduce emissions by increasing the price of carbon-intensive goods, mainly in energy and transport.
Carbon taxation is a policy tool aimed at reducing greenhouse gas emissions by putting a direct price on carbon. By increasing the costs associated with carbon-intensive energy and transport, this mechanism encourages industries and consumers to shift toward cleaner alternatives. It internalizes the environmental costs of pollution, driving innovation in renewable energy and improving overall energy efficiency across economies.

7. (B) Balancing the greenhouse gas emissions produced against those removed from the atmosphere.
Achieving net zero emissions involves a state where the total amount of greenhouse gases released into the atmosphere is perfectly balanced by the amount removed. This balance is reached through a combination of aggressive emission reductions in industrial sectors and the implementation of carbon removal strategies, such as reforestation and advanced carbon capture technologies, to mitigate any remaining residual emissions.

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23. (D) The wealth effect reduces recoverable collateral value, whereas the income effect reduces repayment capacity.
In credit risk management, the wealth effect and income effect represent different transmission channels. The wealth effect occurs when climate-related damage reduces the value of assets pledged as collateral, thereby decreasing the bank's recovery amount in case of default. Conversely, the income effect involves a reduction in the borrower's cash flow or earnings, which directly impairs their ability to service debt.

24. (D) Standardized backward-looking linear amortization scaling
Modern climate risk measurement relies on forward-looking techniques because historical data fails to capture future environmental trajectories. Recognized practices include scenario analysis, which explores plausible future pathways, and sensitivity analysis, which tests specific variables. Natural capital analysis is also used to assess ecosystem dependencies. Standardized backward-looking linear amortization scales are traditional accounting methods and are not designed to evaluate complex climate-related financial risks.

25. (B) Indirect effects of climate change, such as the loss of ecosystem services, inevitably result in lower levels of migration and reduced humanitarian crises.
Physical risk drivers include both acute events like storms and chronic shifts like rising temperatures. Indirect effects of climate change, such as the loss of ecosystem services, are likely to lead to higher levels of migration and increased humanitarian crises, rather than lower levels. These disruptions pose significant challenges to economic stability and can lead to increased credit and operational risks.

26. (D) A system threshold where change becomes abrupt and self-perpetuating even if the initial drivers abate.
A tipping point in the climate system is a critical threshold beyond which a small change can trigger a large, often irreversible transformation. Once this point is reached, the change becomes self-perpetuating even if the original drivers of the change are removed. These thresholds are significant because they introduce extreme non-linearity and unpredictability into climate models and financial risk assessments.

27. (A) Criteria (Environmental, Social, Governance) used in investment decisions or company operations.
Environmental, Social, and Governance criteria represent a set of standards used by investors and organizations to evaluate corporate behavior and future financial performance. These factors help identify risks and opportunities that traditional financial analysis might overlook. By integrating ESG considerations into decision-making, financial institutions can better manage long-term sustainability risks and align their portfolios with broader social and environmental goals.

28. (A) Minimizing waste by designing products to be repaired, reused, and recycled throughout their life cycle.
A circular economy is an economic model designed to minimize waste and maximize resource efficiency. Unlike the traditional linear "take-make-dispose" approach, it focuses on keeping products, materials, and resources in use for as long as possible. This is achieved through designing for durability, repairability, and recycling, which helps reduce the environmental footprint and promotes sustainable long-term economic growth across industries.

29. (C) Their probability can be precisely calculated using forward-looking climate scenarios and models.
Black Swan events are characterized by their extreme rarity, severe impact, and the fact that they are unpredictable before they occur. They can typically only be explained or rationalized after the event has already taken place. Therefore, it is incorrect to suggest that their probability can be precisely calculated using standard forward-looking models, as they lie outside regular statistical distributions.

NODIA

(C) 60%
(D) 80%

May/June 2012

7. Bank regulation is best defined as the framework that governs which of the following?
(A) The formulation of a country's monetary policy and currency printing schedules.
(B) The rules governing bank establishment, ownership, capital, and permitted activities.
(C) The direct management and daily decision-making of commercial banks by the central bank.
(D) The exclusive auditing of non-banking financial companies and unorganized money market participants.

Oct/Nov 2014

8. Which of the following pairings of Reserve Bank of India (RBI) departments and their mandated responsibilities is incorrect?
(A) Department of Banking Operations and Development (DBOD) - Performs regulatory function pertaining to banks.
(B) Financial Institutions Division (FID) - Responsible exclusively for the supervision and regulation of Non-Banking Financial Companies (NBFCs).
(C) Department of Banking Supervision (DBS) - Responsible for the supervision of commercial banks and their merchant banking subsidiaries.
(D) Board for Financial Supervision (BFS) - Provides undivided attention to the prudential supervision and regulation of banks and financial institutions in an integrated manner.

May/June 2019

9. In which year was the Basel Committee on Banking Supervision (BCBS) initially set up by the central-bank Governors of the Group of Ten (G-10) countries?
(A) 1930
(B) 1974
(C) 1988
(D) 1996

Oct/Nov 2006

10. During a period of financial instability, a false rumor spreads that Regional Bank X is heavily exposed to a collapsing real estate conglomerate. Depositors rush to withdraw their funds. Witnessing this, depositors at a completely unaffiliated and healthy Regional Bank Y also panic and withdraw funds, assuming Bank Y is similarly exposed. This behavior is formally termed as:
(A) Regulatory arbitrage
(B) Value-at-Risk modeling
(C) Herding behavior
(D) Cherry picking

May/June 2021

11. Consider the following statements regarding Capital Linked to Credit Risk under the Basel I framework:
I The capital measurement system provided a common framework for capital assessment as a function of the riskiness of fund based and non-fund based exposures.
II All assets in the balance sheet of a bank provide the exact same degree of riskiness.
III Differentiated degrees of riskiness were brought about through specific risk weights.
IV Claims on multilateral development banks generally carried a 20% risk weight.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), and (IV)

Oct/Nov 2010

12. Which of the following statements is correct regarding an efficient and competitive financial system?
(A) Maximum competition guarantees that banks will naturally maintain the highest possible capital adequacy ratios without regulation.
(B) Banking regulation should adopt an approach that needlessly restricts commercial banks to guarantee absolute depositor safety.
(C) Efficiency and competition depend on the number of banks, entry freedom, and the ability to achieve proper size.
(D) Promoting an efficient system dictates that commercial banks must face a

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38. (C) I, III, and IV
Transition risks are driven by policy shifts like subsidies for efficiency, the creation of stranded assets that lose economic value, and changes in public sentiment favoring green companies. Statement two is incorrect because technological advances aim to decrease, not increase, the use of fossil fuels. Together, these drivers push the economy toward lower-carbon operations, creating new risks for traditional industries.

39. (C) Assertion (A) is true, but Reason (R) is false.
While it is true that historical data is insufficient for predicting future climate impacts due to the unprecedented nature of current environmental shifts, the reasoning provided is flawed. The future pathways and timing of physical and transition risks are actually characterized by high uncertainty rather than high certainty. This unpredictability makes traditional backward-looking risk assessment methods unreliable for managing long-term climate exposures.

40. (D) Reputational Risk – Disruption in the bank's daily business continuity resulting from physical damage to its own leased data centers. Reputational risk involves negative public perception or loss of trust, whereas the disruption of daily business operations due to physical damage to data centers is classified as operational risk. The other pairs correctly describe the income effect on cash flows, the wealth effect on collateral value, and liquidity risk arising from sudden post-disaster fund withdrawals and high demand for loans.

41. (B) Stranded assets
As the economy transitions toward cleaner technologies like electric vehicles, older assets tied to fossil fuels may become obsolete. When manufacturing plants for internal combustion engines can no longer generate an economic return due to changes in regulation or consumer demand, they are termed stranded assets. These assets represent a significant financial loss and a key component of transition risk for banks.

42. (C) P-2, Q-3, R-4, S-1
International frameworks for green finance categorize regulations into four groups. The first focuses on sustainability disclosures. The second involves directed lending through revolving funds. The third category encompasses micro and macro-prudential regulations like differential reserve requirements. The fourth category relates to the establishment of dedicated green financial institutions to support the transition toward a more sustainable global economy.

43. (C) I, II, and III
The Board of Directors is responsible for high-level strategy, overseeing risk frameworks, and fostering a risk-aware culture within the bank. They ensure that systems and controls are in place to manage climate-related risks effectively. However, establishing daily internal escalation processes for operational exceptions is a management-level task, as the Board's role is focused on oversight and strategic direction.

44. (C) I and III
Climate change is a unique financial risk because its impacts are far-reaching across multiple sectors and geographies. It is also characterized by non-linearities and tipping points that can lead to abrupt and massive changes. Statement two is incorrect because the timing and outcomes of climate risks are highly uncertain and unpredictable, rather than certain, making them difficult to model.

45. (C) The wealth effect
When a physical disaster like a cyclone destroys assets that have been pledged as security for a loan, the recoverable value of those assets drops significantly. This specific mechanism of credit risk, where the loss of collateral value impacts the lender's security, is known as the wealth effect. It differs from the income effect, which focuses on the borrower's earnings.

46. (B) P-3, Q-1, R-4, S-2
Climate risks manifest in several ways: credit risk occurs when borrowers cannot service debt; market risk involves the abrupt repricing of financial assets; liquidity risk arises from sudden surges in fund withdrawals; and operational risk results from physical damage to a bank's property or data centers. These categories help financial institutions systematically assess their overall vulnerability to environmental changes.

NODIA

30. (D) Green Swans involve complex chain reactions that could pose an existential threat to humanity.
While both involve extreme events, Green Swans differ from traditional Black Swans because there is a higher certainty that climate-related risks will eventually materialize. They involve complex, non-linear chain reactions and feedback loops that can lead to cascading systemic failures. These events pose an existential threat to humanity and are far more complex than conventional financial shocks found in historical data.

31. (C) Second line – Ensure adherence to rules and adopt escalation procedures to report material risks.
In the three lines of defence model for risk management, the first line is responsible for identifying and managing risks during daily operations. The second line, which includes the risk management and compliance functions, ensures adherence to rules and monitors the overall risk framework. The third line consists of the internal audit function, which provides independent assurance on the effectiveness of controls.

32. (B) I, II, III, and IV
Senior management is responsible for implementing the environmental risk management framework and ensuring its ongoing effectiveness. Their duties include reviewing tools and metrics, establishing internal escalation processes for material exposures, and providing timely updates to the Board. Focusing exclusively on short-term financial interests is incorrect, as effective climate risk management requires a long-term strategic perspective to ensure institutional resilience.

33. (B) P-4, Q-3, R-2, S-1
Different tools are used to measure climate risk. Climate risk scores assign quality ratings to exposures based on specific criteria. Stress testing evaluates near-term resiliency to severe shocks. Sensitivity analysis examines the effect of changing a single variable. Natural capital analysis identifies how a portfolio depends on natural resources like water and forests. These tools provide a comprehensive view of vulnerabilities.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Climate change is termed a green swan because it involves catastrophic events that are increasingly certain to occur, though their exact timing remains uncertain. These risks are characterized by high complexity and non-linearity, posing existential threats that exceed the scope of traditional black swan events. The reasoning correctly explains why the term green swan is used to describe these unique climate-related risks.

35. (B) Only (II)
The survey on climate risk and sustainable finance released in two thousand twenty-two was comprehensive and covered a wide range of banks, not just public sector ones. However, financial data confirms that at the end of March two thousand twenty, the aggregate outstanding bank credit to India's non-conventional energy sector reached approximately thirty-six thousand five hundred forty-three crore rupees.

36. (A) The income effect
The scenario describes a situation where a natural disaster destroys a borrower's ability to generate revenue. Because the farming corporate can no longer produce harvests or cash flow, its capacity to repay its loans is directly compromised. In the context of credit risk transmission, this specific reduction in the borrower's debt-servicing ability is known as the income effect.

37. (A) P-4, Q-2, R-3, S-1
India's climate commitments include reducing the emissions intensity of its GDP by forty-five percent by two thousand thirty. The country also aims to achieve fifty percent cumulative electric power capacity from non-fossil sources by two thousand thirty and create a carbon sink of up to three billion tons. The long-term goal is to reach net zero emissions by two thousand seventy.

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55. (A) I, II, and III
Natural capital analysis involves identifying specific geographies and sectors, mapping the relevant natural assets like water and air, and determining potential disruptions. Statement four is incorrect because calculating Climate Value-at-Risk using traditional macroeconomic variables is a different type of financial modeling. Natural capital analysis specifically focuses on ecological dependencies and the risks associated with the degradation of natural resources.

56. (A) P-3, Q-4, R-2, S-1
Green finance refers to broad financial arrangements for sustainable projects. A green loan is a specific debt instrument for eco-friendly purposes. Green bonds are debt securities where proceeds are ring-fenced for environmental initiatives. Carbon taxation is a fiscal policy that levies taxes on carbon content to discourage emissions. These concepts form the foundation of the sustainable finance ecosystem.

57. (A) Chronic physical risk
Chronic physical risks are characterized by long-term, gradual shifts in climate patterns. The persistent rise in sea levels over several decades is a classic example of such a risk, as it slowly increases the vulnerability of coastal assets and industries. Unlike acute risks, which involve sudden events, chronic risks require long-term strategic planning to mitigate the eventual impact on lending portfolios.

58. (A) Only (I)
Scientific data indicates that global temperatures have increased by approximately one degree Celsius since eighteen fifty. Statement two is incorrect because the primary goal of the Paris Agreement is to limit warming to well below two degrees Celsius, and ideally to one point five degrees, rather than a maximum of exactly three degrees Celsius. This target is essential for preventing catastrophic.

59. (B) I, II, III, and IV
Banks can mitigate climate risk through various strategies, such as setting tenor limits for vulnerable sectors, adjusting loan-to-value ratios for non-sustainable real estate, and requiring insurance for weather-dependent businesses. They may also require carbon-intensive firms to have transition strategies. However, immediately terminating all credit to any entity with non-zero emissions is not a standard or practical risk management approach.

60. (A) I and II
Climate change affects credit risk through the wealth effect, where asset damage reduces collateral value, and the income effect, where damaged property reduces the borrower's cash flow. Statement three is incorrect because chronic physical risks, like rising sea levels, can definitely have significant negative impacts on long-term credit exposures by gradually making certain business activities or locations unviable.

61. (C) Climate stress testing
Climate stress testing is the most appropriate tool for evaluating a bank's capital adequacy and resiliency against severe but plausible economic shocks. It allows the institution to simulate various future scenarios, such as an abrupt shift away from fossil fuels, and assess the potential impact on its financial position. This process helps ensure that the bank remains solvent during transition periods.

62. (A) The second line of defence
Within the three lines of defence model, the internal compliance team acts as the second line. Their role is to provide independent oversight and ensure that the first line of defence, which includes relationship managers, adheres to the established risk management framework and regulatory requirements. This structure helps maintain the integrity and consistency of the bank's climate risk assessments.

63. (C) Credit risk arising from transition risk
When external agencies downgrade a company's credit rating due to policy shifts like carbon taxes or changing consumer preferences, it signals an increased likelihood of default. For the bank, this represents a rise in credit risk. Since this specific risk is driven by the societal move toward a low-carbon economy, it is classified as a consequence of transition risk.

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supersede all previously established domestic parliamentary acts.

Oct/Nov 2007

18. Systemic risk is best defined as:
(A) Financial service disruption from system impairment, causing serious real economy damage.
(B) The risk that changes in market prices will cause unexpected losses in off-balance sheet trading positions.
(C) The risk associated with the daily operational and technical failures isolated within a single bank branch.
(D) A social cost that is suffered by a third party strictly as a consequence of a transparent economic transaction.

May/June 2025

19. Consider the following statements regarding the Bank for International Settlements (BIS):
I It was established in Basel, Switzerland, in 1930.
II It acts as a prime counterparty for central banks in their financial transactions.
III It functions as a strict global supervisory authority with binding legal force over all member banks.
IV It serves as a prominent center for economic and monetary research.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

Oct/Nov 2019

20. Match the regulatory objective in List I with its primary mechanism or description in List II:
List I: (Objective)
P. Consumer Protection
Q. Efficient and Competitive Financial System
R. Monetary and Financial Stability
S. Bank Supervision
List II: (Mechanism/Description)
1. Keeps fluctuations in business activity from interrupting transaction flows.
2. Ensures equal access to credit and meaningful disclosure.
3. Depends on freedom of entry and preventing collusive pricing.
4. Entails monitoring the overall system and enforcing rules with penalties.
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2009

21. All of the following were recognized main features of the 1988 Basel-I Accord, EXCEPT:
(A) It systematically set minimum capital standards for internationally active banks.
(B) It formally became effective at the end of 1992.
(C) The regulatory focus was primarily directed toward operational and market risk.
(D) It aimed to prevent international banks from building massive business volumes without adequate capital backing.

Oct/Nov 2011

22. Read the following statements regarding consumer protection in banking:
I The main intent behind disclosures of deposit and credit terms is to give customers a basis for comparing and making informed choices.
II Equal treatment under consumer protection legislation aims to ensure equal access to credit among all financial customers.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

NODIA

May/June 2010

23. All of the following statements are true regarding the negative externalities associated with bank failures, EXCEPT:
(A) Bailouts of distressed banks often entail immense costs that are shouldered by society as a whole.
(B) Depositors' incentives to rigorously monitor the financial condition of their bank are significantly reduced when protected by guarantees.

CHAPTER 23

Why do Banks Need Regulation

May/June 2016

1. Which of the following statements is incorrect regarding the contagion effects of a bank failure?

(A) Systemic risk can lead to widespread bank runs and the eventual collapse of the broader banking system.

(B) Banks transform short-term liquid deposits into long-term illiquid assets, creating an inherently unstable system prone to runs.

(C) Information asymmetry and the limited ability of market participants to process information can exacerbate herding behaviors.

(D) Contagion arises because liquidated bank assets usually appreciate in value quickly once a bank run begins.

Oct/Nov 2009

2. Why was the setting of international standards, such as those promulgated by the BCBS, considered crucial for the global financial system?

(A) To permanently centralize the monetary policy of all participating countries into a single global central banking authority.

(B) To assure that international banks are never required to hold capital against non-credit operational risks.

(C) To prevent a race to the bottom where jurisdictions lower prudential rules to attract foreign financial firms.

(D) To legally transfer the supervisory responsibility of all domestic bank branches exclusively to foreign host countries.

May/June 2023

3. Why do bank depositors face unique challenges in protecting their interests compared to customers of other types of businesses?

(A) Depositors exclusively utilize banks for cashing cheques and avoid long-term savings.

(B) Depositors primarily focus on maximizing interest rates without considering the bank's underlying credit risks.

(C) Depositors act as creditors, making it costly to assess bank health using complex, confidential data.

(D) Depositors lack the legal standing to file consumer complaints in modern financial systems.

Oct/Nov 2018

4. GlobalBank USA opens a massive new branch in London. Prior to 1975, the US regulatory rules did not apply to the London branch, and the UK regulators lacked the power to supervise it as it was owned by a US parent. Which specific paper was issued as a first step to close such gaps in international supervisory coverage?

(A) The Basel-I Capital Accord

(B) The Market Risk Amendment

(C) The Concordat

(D) The Minimum Standards for Supervision

May/June 2007

5. MegaBank undertakes highly speculative derivative investments that generate massive short-term profits, triggering large performance bonuses for management. However, when the investments crash, the government is forced to step in with taxpayer money to prevent a systemic market collapse. This scenario perfectly illustrates which concept?

(A) Direct market discipline

(B) Negative externalities

(C) Positive risk-weighted arbitration

(D) Operational risk mitigation

Oct/Nov 2025

6. By what percentage did the gross amount of funds transferred among banks for the purpose of payments and settlements fall in the three days immediately following Herstatt's closure?

(A) 40%

(B) 50%

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47. (C) Assertion (A) is true, but Reason (R) is false.
Banks indeed face significant reputational risk if they are perceived to be financing activities that harm the environment. This negative perception can damage their brand and alienate stakeholders. However, the reason provided is false because negative perceptions would actually hinder, not help, the establishment of relationships with progressive ESG investors, who prioritize sustainability and responsible financing in their partnerships.

48. (B) Acute Physical Risk – Shifts in consumer sentiment and investor behaviour leading to stranded assets.
Acute physical risks refer specifically to sudden and extreme weather events like heatwaves, storms, and wildfires that cause immediate damage. Shifts in consumer sentiment and investor behavior, which can lead to stranded assets, are actually classified as drivers of transition risk. Transition risks are associated with the move toward a low-carbon economy rather than the direct physical impacts of climate.

49. (A) I, II, III, and IV
Effective climate risk management requires banks to clearly define roles, assess risks at both customer and portfolio levels, and implement robust internal controls. Monitoring and reporting to senior management are also essential. Completely outsourcing these assessments without internal review is incorrect, as banks must maintain internal expertise and accountability to effectively manage their unique risk exposures and ensure regulatory compliance.

50. (B) Only II
While traditional data on green finance awareness may be limited, modern tools like Google Trends can provide valuable insights into public interest in sustainable development over time. Contrary to statement three, green financing actually seeks to increase, not decrease, the flow of private capital toward sustainable priorities. This helps align financial markets with global environmental goals and supports the transition.

51. (D) Mitigation policy driver (Transition risk)
The sudden introduction of a carbon tax is a prime example of a transition risk driver, specifically a mitigation policy. These policies are designed to reduce greenhouse gas emissions by making carbon-intensive activities more expensive. For companies like AutoDrive Corp, such shifts necessitate significant operational changes and can impact financial viability, representing a move toward a more sustainable, low-carbon economy.

52. (D) Mitigation policy – Subsidies to encourage the use of energy-efficient goods and processes.
Mitigation policies include government actions like providing subsidies to encourage the adoption of energy-efficient technologies. In contrast, sudden floods are acute physical risks, not chronic. Chronic risks refer to gradual changes like rising temperatures, while the degradation of marine ecology is a physical risk rather than a technological transition risk. This distinction is crucial for accurate risk identification and management.

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53. (B) Only (II)
Senior management is responsible for the day-to-day management of environmental risks, including the allocation of necessary resources and expertise. Statement one is incorrect because the Board of Directors typically focuses on high-level oversight and strategy, while the actual implementation and management of internal escalation processes for daily material exposures are the responsibility of senior management and operational leaders.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Extreme weather events can significantly stress a bank's liquidity position. Natural disasters cause widespread damage, prompting individuals and businesses to withdraw funds for repairs and emergency needs. Simultaneously, there is often a higher demand for new loans to fund reconstruction. This combination of reduced deposits and increased credit demand explains why climate events can indirectly impact a bank's liquidity stability.

competitive disadvantage against less regulated financial entities.

May/June 2005

13. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct option:
Assertion (A): With reforms in the banking sector adding autonomy and competitive dimensions, banking supervision had to be systematically weakened to ensure full operational freedom.
Reason (R): Supervision has to be strengthened to ensure that banking autonomy does not compromise safety, sustainability, and consumer protection.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2022

14. Consider the following statements about banking regulation and supervision:
I Bank regulation extensively covers the entry of new banks, ownership, and permitted financial activities.
II Bank supervision exclusively entails the formulation of new parliamentary laws governing the banking sector.
III Basel-II (2004) introduced the Supervisory Review Process (SRP) to highlight the need for risk management through institutionalized oversight.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2018

15. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct option:
Assertion (A): The collapse of Herstatt Bank dramatically highlighted the close interdependence among international banks and gave rise to the term "Herstatt risk".
Reason (R): Herstatt Bank was closed by German supervisors at lunchtime, leaving US counterparties who had already paid in German marks unable to receive their dollar exchanges when New York markets opened later in the day.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2016

16. Which of the following statements about depositors' interests is incorrect?
(A) Assessing bank asset values is a simple and cost-effective process for most depositors.
(B) Bank customers who maintain a deposit account assume the role of bank creditors.
(C) Bank depositors' fortunes become inherently linked with the overall fortunes of their bank.
(D) A significant portion of the information needed to evaluate the true condition of a bank may be confidential.

May/June 2014

17. The Central Bank of Country Z wishes to completely overhaul its banking regulations and looks to the BCBS for guidance. The Central Bank incorrectly assumes that BCBS regulations are legally binding laws. How should the authority of BCBS recommendations be correctly applied by Country Z?
(A) As broad supervisory standards and best practices implemented through detailed domestic arrangements.
(B) As strictly enforced global laws backed by an international banking court.
(C) As informal suggestions that only apply to banks headquartered within the European Union.
(D) As legally binding treaties that completely

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64. (C) Faster Adoption and Manufacturing of Hybrid and Electric Vehicles.
FAME stands for Faster Adoption and Manufacturing of Hybrid and Electric Vehicles. This is a flagship scheme by the Government of India designed to promote the use of electric and hybrid vehicles through purchase incentives and the development of necessary charging infrastructure. The program is a key part of India's strategy to reduce emissions and dependence on imported fossil fuels.

65. (B) Sensitivity analysis
Sensitivity analysis is a technique used to understand how changes in a single input variable affect a specific outcome. By altering only the carbon price while keeping other factors constant, the bank can isolate the direct impact of that policy change on its lending portfolio. This method provides valuable insights into the specific vulnerabilities of different sectors to carbon pricing mechanisms.

66. (D) The first line of defence
In the three lines of defence model, the first line consists of the business units and functions that directly interact with customers and generate risk. Relationship managers in the corporate lending division belong to this line, as they are responsible for performing the initial risk assessments and managing exposures at the point of origin during the loan application process.

67. (C) ₹30 crore
The Reserve Bank of India's Priority Sector Lending guidelines establish specific loan limits to encourage investment in sustainable sectors. For the renewable energy industry, bank loans up to thirty crore rupees for purposes such as solar power generators, biomass plants, and wind mills are categorized under the priority sector. This helps channel capital toward projects that contribute to the national green energy goals.

68. (A) Climate Value-at-Risk (VaR)
Climate Value-at-Risk is a forward-looking metric that quantifies potential financial losses in a portfolio over a specific time period and at a certain probability level. By using scenarios like two degrees of warming, it helps banks estimate how much asset value might be at risk from climate change. This tool is essential for long-term strategic planning and risk management.

69. (B) The third line of defence
The internal audit function serves as the third line of defence in a risk management framework. Its primary responsibility is to provide independent and objective assurance on the effectiveness of the bank's internal controls and risk management processes. By reviewing the quality of climate risk data and the overall control framework, the audit group ensures that the institution's disclosures are accurate.

70. (B) Green bonds
Green bonds are fixed-income instruments specifically designed to raise funds for projects that have positive environmental or climate benefits. The proceeds from these bonds are legally ring-fenced, meaning they must be used exclusively for eligible green projects, such as sustainable forestry, renewable energy, or clean transportation. They provide a vital mechanism for directing large-scale capital toward the green transition.

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(C) Risk exposures originating at one institution can endanger the survival of other interconnected institutions.
(D) Large financial institutions bear all absolute risks and potential losses of their complex portfolios.

Oct/Nov 2024

24. Which of the following correctly describes the legal authority of the Basel Committee on Banking Supervision (BCBS)?
(A) Reports and recommendations issued by the committee have strict legal force across all member jurisdictions.
(B) The committee possesses the sovereign authority to micromanage member countries' daily supervisory approaches.
(C) The committee's primary legal role is to act as a trustee in connection with centralized international financial operations.
(D) It sets broad supervisory standards for local authorities to implement via arrangements suited to national interests.

May/June 2017

25. Alpha Bank has recently engaged in aggressive lending practices that severely compromise the interests of its depositors. To intervene, the Reserve Bank of India decides to issue specific operational directives to Alpha Bank. Under which statutory provision is RBI empowered to issue such directions in the public interest?
(A) Section 35 of the Reserve Bank of India Act, 1934
(B) Section 35A of the Banking Regulation Act, 1949
(C) Section 35 of the Banking Regulation Act, 1949
(D) Section 35A of the Reserve Bank of India Act, 1934

Oct/Nov 2005

26. How does banking regulation specifically foster monetary and financial stability?
(A) By ensuring that banks restrict output and fix prices to avoid market competition.
(B) By controlling the volume of money circulating, operating entirely independently of the central bank.
(C) By completely eliminating operational risks through the enactment of stringent customer disclosure acts.
(D) By building strong, liquid banks and discouraging practices that harm depositors and payment systems.

May/June 2020

27. Match the document or event in List I with its corresponding year of issue or occurrence in List II:
List I: (Document/Event)
P. Revision of Concordat as 'Principles for the supervision of banks' foreign establishments'
Q. Release of Basel I Accord
R. First issue of the Concordat
S. Supplement on 'Exchange of information between supervisors'
List II: (Year)
1. 1983
2. 1975
3. 1990
4. 1988
(A) P-1, Q-4, R-2, S-3
(B) P-2, Q-3, R-1, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2015

28. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct option:
Assertion (A): Implicit and explicit government guarantees intended to instill confidence and provide stability can inadvertently distort the incentives of bank managers.
Reason (R): Government guarantees incentivize banks to take on riskier investments because economic profits from excessive risk-taking are privately captured, while losses are socialized.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2013

29. What best describes the fundamental rationale underpinning the multilateral approach

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May/June 2017

67. Arrange the following historical milestones in global and Indian banking regulation in chronological order:

I Establishment of the Board for Financial Supervision (BFS) by RBI
II Collapse of Herstatt Bank
III Release of the Market Risk Amendment to the Capital Accord
IV Release of the original Basel-I Accord

(A) (II), (IV), (I), (III)
(B) (II), (I), (IV), (III)
(C) (IV), (II), (III), (I)
(D) (I), (II), (IV), (III)

Oct/Nov 2005

68. Read the following events and timeline announcements issued by the Reserve Bank of India:

I Oct 30, 1998: Announcement to raise CRAR from 8 per cent to 9 per cent.
II April 27, 2007: RBI announced final guidelines for implementation of Basel II.
III Dec 30, 2011: RBI issued draft guidelines for implementation of the proposed Basel III capital regulations.
IV March 27, 2014: RBI revised Basel-III capital regulation timeline from Mar 31, 2018 to Mar 31, 2019.
V March 01, 2016: RBI allowed banks to expand the capital base to meet Basel-III by including the value of property.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III) only
(B) (I), (II), and (IV) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

May/June 2020

69. Consider the following categories of periodic disclosure for banks under Pillar 3:

I Risk exposure
II Capital adequacy
III Methods for computing capital requirements
IV Material information that could affect the decision-making of the agent using the information

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2015

70. Consider the following statements regarding banking regulation:

I The primary reason to regulate banks is the protection of depositor's interest.
II Bank regulation targets to keep fluctuations in business activity from interrupting the flow of economic transactions.
III At a global level, the benchmark banking regulation standard is set by the Basel Committee on Banking Supervision.
IV The Concordat set out critical principles for sharing supervisory responsibility for banks' foreign branches.
V Basel II formed the basis for identification, measurement, and monitoring of risks using a comprehensive three-pillar approach.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III), and (IV) only
(B) (I), (III), (IV), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

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announcement in its Mid-term Review of Monetary and Credit Policy for 1998-99 to raise the CRAR from 8 per cent to what specific percentage?
(A) 8.5 per cent
(B) 9 per cent
(C) 10 per cent
(D) 12 per cent

Oct/Nov 2013

36. Which of the following Pillar 1 approaches is strictly and exclusively associated with the measurement of Operational Risk?
(A) Basic Indicator Approach
(B) Foundation IRB Approach
(C) Internal Model Approach
(D) Standardised Approach

May/June 2015

37. Consider the following bank assets:
I Cash items in the process of collection
II Claims on central governments denominated in national currency
III Loans fully securitized by mortgage on residential property
IV Claims collateralized by cash of OECD government securities
V Premises, plant, and equipment
Which of the above assets explicitly carry a 0% risk weight under Basel-I?
(A) (I) and (II)
(B) (II) and (IV)
(C) (III), (IV), and (V)
(D) (I), (II), and (V)

Oct/Nov 2012

38. Market risk, as officially incorporated in the 1996 Amendment to the Capital Accord, is defined as:
(A) The risk of widespread, uncontrollable bank runs across the national financial system.
(B) The risk of catastrophic loss arising from inadequate or failed internal processes, people, and systems.
(C) The risk that a primary counterparty fails to fulfill their contractual obligations upon maturity.
(D) The risk that market price changes cause losses in trading positions, both on- and off-balance sheet.

May/June 2011

39. Which of the following pairings of the Three Pillars of Basel II is demonstrably incorrect?
(A) Pillar 1 - Minimum Capital Requirement
(B) Pillar 2 - Supervisory Review Process
(C) Pillar 3 - Market Discipline
(D) Pillar 1 - Supervisory Intervention and Solvency Reports

Oct/Nov 2020

40. Gamma Bank possesses the following balance sheet items: Equity ₹ 2000 million, Disclosed Reserves ₹ 1000 million, Subordinated Debts ₹ 800 million, and General Loan Loss Reserves ₹ 200 million. Assuming there are no mandatory deductions, what is the calculated amount of Tier-I Capital and Total Capital respectively?
(A) Tier-I: ₹ 3000 million, Total Capital: ₹ 4000 million
(B) Tier-I: ₹ 2000 million, Total Capital: ₹ 4000 million
(C) Tier-I: ₹ 3000 million, Total Capital: ₹ 3800 million
(D) Tier-I: ₹ 3800 million, Total Capital: ₹ 4000 million

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May/June 2022

41. Bank Beta's core capital levels have begun a sustained downward trend, dangerously approaching the minimum required limits due to a sudden surge in non-performing assets. Under Principle 4 of the Supervisory Review Process, what immediate proactive approach is the national supervisor expected to take?
(A) Liquidate the bank immediately to protect the national deposit insurance fund.
(B) Intervene early to prevent capital from falling below minimum levels and require rapid, necessary remedial action.
(C) Passively wait until the capital explicitly falls below the absolute minimum before taking any formal action.
(D) Publish a public notice of impending insolvency in national newspapers to warn depositors to withdraw funds.

Oct/Nov 2023

42. Which of the following statements concerning the components of capital under the Cooke Ratio framework is incorrect?
(A) Core Capital (Tier I) includes Paid Up Capital and Disclosed Reserves.

to financial regulation and the creation of international standards-setting bodies like the BCBS?
(A) To enforce a single, unalterable global currency across all participating nations.
(B) To guarantee that all national governments provide infinite deposit insurance coverage regardless of bank size.
(C) To prevent fragmented frameworks that hinder trust, split capital pools, and increase systemic risks.
(D) To transfer all commercial banking operations to the direct control of the Bank for International Settlements (BIS).

Oct/Nov 2021

30. What is the primary rationale for requiring supervisory or counterparty discipline in addition to prescribing statutory regulations?
(A) To maximize the short-term profitability and dividend payouts of the national banking sector.
(B) To ensure strict adherence to internal bank bylaws without requiring any external oversight or penalties.
(C) To replace internal audits and eliminate the need for independent corporate governance within banks.
(D) To incentivize rule compliance, as regulations lack practical effect without oversight and penalties.

May/June 2024

31. Bank Zenith currently holds a commercial loan of ₹ 500 million extended to a private sector company. Under the Basel I framework, this loan falls into a category requiring a 100% risk weight. Applying the Cooke Ratio, what is the absolute minimum capital requirement Bank Zenith must maintain specifically for this loan?
(A) ₹ 20 million
(B) ₹ 40 million
(C) ₹ 50 million
(D) ₹ 100 million

Oct/Nov 2008

32. A young trader at a Singapore subsidiary of a prominent London-based merchant bank accumulated huge, devastating losses by hiding derivative trades in an excluded file known as Error Account 88888. The trader effectively had control over both trading and settlement. This catastrophic failure of internal controls most notably led to the collapse of which historic institution in 1995?
(A) Lehman Brothers
(B) Baring Brothers
(C) Herstatt Bank
(D) ING Bank

May/June 2006

33. Match the asset types in List I with their corresponding Basel I risk weights in List II:
List I: (Asset Type)
P. Claims on OECD central governments
Q. Claims on banks incorporated outside the OECD with residual maturity of over one year
R. Claims on OECD banks
S. Claims on domestic public sector entities
List II: (Risk Weight)
1. 100% Risk Weight
2. At National Discretion
3. 0% Risk Weight
4. 20% Risk Weight
(A) P-2, Q-3, R-1, S-4
(B) P-3, Q-1, R-4, S-2
(C) P-1, Q-4, R-2, S-3
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2017

34. Match the type of risk or approach in List I with its corresponding classification under Pillar 1 of Basel II in List II:
List I: (Risk/Approach)
P. Operational Risk (Advanced)
Q. Credit Risk (Foundation)
R. Operational Risk (Basic)
S. Market Risk (Internal)
List II: (Classification)
1. Internal Model
2. Foundation IRB Approach
3. Basic Indicator Approach
4. Advanced Measurement Approach
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2008

35. In line with the international regulatory standard, the Reserve Bank of India officially adopted the Basel I Accord and made an

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May/June 2012

49. All of the following were distinct factors contributing to the spectacular failure of Barings Bank, EXCEPT:

(A) The early regulatory shutdown by German authorities before the New York financial markets opened.

(B) The head trader was directly in charge of both buying and selling ("trading" and "settlement") without independent oversight.

(C) The systematic use of fraudulent entries to fix an important account to zero on month-ends to disguise rapidly growing positions.

(D) Falsified reports were regularly submitted to SIMEX in order to artificially reduce the required margin calls.

Oct/Nov 2014

50. Bank Nova heavily utilizes complex securitization to group its corporate loans into tranches. It aggressively sells off the highest-rated, least risky tranches while retaining the most toxic, unrated equity tranches on its books, a practice that formally complies with early risk weight rules but significantly increases its actual risk profile. This specific practice was heavily criticized under Basel I as:

(A) Risk mitigation

(B) Hedge accounting

(C) Cherry picking

(D) Cross-border contagion

May/June 2019

51. Under Principle 3 of the Supervisory Review Process (Pillar 2), what are national supervisors explicitly expected to require from regulated banks?

(A) Banks should operate exactly at the minimum regulatory capital ratios without holding any unproductive excess capital.

(B) Banks must fully and unconditionally disclose their entire Tier 3 capital structure to the public on a weekly basis.

(C) Supervisors should rely exclusively on the banks' internal auditors and continuously refrain from taking independent supervisory action.

(D) Supervisors should expect banks to hold capital above the minimum and have the power to require extra capital if necessary.

Oct/Nov 2006

52. According to the target standard ratio formulated by the Basel Committee, what is the precise formula to calculate the Cooke Ratio?

(A) $\text{Cooke Ratio} = \dfrac{\text{RiskWeighted Assets}}{\text{Capital}} \geq 8$

(B) $\text{Cooke Ratio} = \dfrac{\text{CoreCapital}}{\text{TotalAssets}} \geq 8$

(C) $\text{Cooke Ratio} = \dfrac{\text{TierII Capital Risk}}{\text{WeightedAssets}} \geq 8$

(D) $\text{Cooke Ratio} = \dfrac{\text{Capital}}{\text{RiskWeightedAssets}} \geq 8$

May/June 2021

53. Continuing from the previous scenario where the bank's total RWA is ₹ 4000 million, if the bank currently holds Tier-I Capital of ₹ 400 million and Tier-II Capital of ₹ 100 million with absolutely no deductions, what is its Basel I risk asset ratio, and does it successfully meet the Cooke Ratio requirement?

(A) 12.5%, Yes it meets the requirement.

(B) 10.0%, Yes it meets the requirement.

(C) 8.0%, Yes it meets the requirement.

(D) 12.5%, No it does not meet the requirement.

Oct/Nov 2010

54. Which of the following statements concerning the key developments leading to the formulation of Basel II is incorrect?

(A) The rapid increase in securitizations of mortgages allowed banks to frequently engage in regulatory arbitrage under Basel I rules.

(B) The Basel II framework deliberately aimed to align regulation with best practices in advanced risk management.

(C) Increased internal modeling showed that Basel I risk weights perfectly matched banks' best estimates of actual risk.

(D) Basel II formally recognized operational risk as an entirely additional element for determining capital allocation.

May/June 2005

55. Omega Bank operates a highly active proprietary trading desk. To calculate the requisite capital charge related to market risk, Omega Bank intends to utilize short-

term subordinated debt with a maturity of 18 months. Under the 1996 Market Risk Amendment, this specific type of capital is newly categorized as:
(A) Tier 1 Capital
(B) Tier 2 Capital
(C) Tier 3 Capital
(D) Tier 4 Capital

Oct/Nov 2022

56. Read the following statements regarding Basel I risk weighting categories:
I Claims on domestic public sector entities (excluding central governments) are strictly subject to a rigid 50% risk weight globally.
II Claims on commercial companies owned by the public sector carry a 100% risk weight.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2018

57. Delta Bank is comprehensively upgrading its risk management systems to fully comply with Pillar 1 of Basel II. It decides to use an approach for calculating credit risk that relies partially on its own internal data but still firmly adheres to foundational regulatory parameters set by the supervisor. Which specific approach is Delta Bank adopting?
(A) Foundation IRB Approach
(B) Standardised Approach
(C) Basic Indicator Approach
(D) Advanced Measurement Approach

Oct/Nov 2016

58. A domestic commercial bank has the following distinct assets on its balance sheet: Cash ₹ 100 million, Government Bonds ₹ 200 million, Mortgage Loans ₹ 4000 million, and Loans to Corporates ₹ 2000 million. Applying the standard Basel I risk weights, calculate the total Risk Weighted Assets (RWA) for the bank.
(A) ₹ 6300 million
(B) ₹ 2000 million
(C) ₹ 4000 million
(D) ₹ 6000 million

May/June 2014

59. Consider the following statements regarding Tier 3 capital as introduced in the 1996 Amendment:
I It was structurally defined as short-term subordinated debt with an original maturity of at least 2 years.
II It was permitted to be used by banks exclusively when computing the capital charge related to market risk.
III It mandated that the principal must be repaid immediately upon maturity even if it results in the bank falling below minimum capital requirements.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2007

60. The following question consists of two statements, an Assertion (A) and a Reason (R). Select the correct option:
Assertion (A): Sophisticated banks were frequently able to engage in "cherry picking" under the Basel-I framework.
Reason (R): The wide breadth and absoluteness of Basel I's risk weightings allowed banks to securitize their corporate loans and sell off the least risky assets, artificially appearing protected while taking on greater risk.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2025

61. Arrange the following critical announcements by the Reserve Bank of India regarding Basel implementation in chronological order:
I Allowed banks to expand the capital base to meet Basel-III by including property

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value.
II Issued draft guidelines for implementation of the proposed Basel III capital regulations.
III Revised Basel-III capital regulation timeline to Mar 31, 2019.
IV Announcement to adopt stricter measures of Basel III framework governing improved risk management systems.
(A) (II), (IV), (III), (I)
(B) (I), (II), (III), (IV)
(C) (IV), (II), (I), (III)
(D) (II), (III), (IV), (I)

Oct/Nov 2019

62. What is the fundamental, primary objective of Pillar 3 (Market Discipline) under the Basel II regulatory framework?
(A) To improve risk management by enabling market participants to reward well-managed banks through increased transparency.
(B) To impose rigid, non-negotiable caps on the salaries and bonuses of senior banking executives.
(C) To strictly mandate the creation of a centralized deposit insurance fund across all Basel Committee member states.
(D) To explicitly dictate the specific financial derivative instruments a bank is legally permitted to trade.

May/June 2009

63. All of the following are recognized principles of supervisory review under Pillar 2 of Basel II, EXCEPT:
(A) Banks should possess a robust process for assessing their overall capital adequacy in relation to their specific risk profile.
(B) Supervisors should rigorously review and evaluate banks' internal capital adequacy assessments and strategies.
(C) Supervisors must ensure banks never hold capital exceeding minimum ratios to avoid potential regional economic stagnation.
(D) Supervisors should actively seek to intervene at an early stage to prevent capital from falling below critical minimum levels.

Oct/Nov 2011

64. Which of the following terms is correctly paired with its core conceptual definition?
(A) Negative externality - The direct operational cost incurred by the government when imposing corporate taxes on financial firms.
(B) Bank supervision - The drafting of new national legislation by the parliament to charter banks.
(C) Systemic risk - Widespread disruption to financial services that could significantly damage the real economy.
(D) Basel I - The specific regulatory framework that originally introduced the mandatory Pillar 2 and Pillar 3 approaches.

May/June 2010

65. Sigma Bank, an internationally active and highly interconnected financial institution, is finalizing its external disclosure schedules for the upcoming financial year. According to standard Pillar 3 guidelines, how frequently should Sigma Bank ideally disclose its critical risk exposure to the public?
(A) Annually
(B) Semi-annually
(C) Quarterly
(D) Monthly

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Oct/Nov 2024

66. Match the components of the Basel Guidelines in List I with their corresponding elements or functions in List II:
List I: (Component)
P. Pillar 2
Q. Pillar 1
R. Pillar 3
S. 1996 Amendment
List II: (Element/Function)
1. Capital transparency and Scope
2. Solvency reports and Regulatory intervention
3. Risk weighted assets (RWA) for credit risk
4. Value-at-risk models for market risk
(A) P-1, Q-4, R-2, S-3
(B) P-2, Q-3, R-1, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

and regulation of Non-Banking Financial Companies (NBFCs).
The Financial Institutions Division within the Reserve Bank of India is not exclusively responsible for Non-Banking Financial Companies. Instead, it handles the supervision and regulation of select all-India financial institutions. Responsibilities for various entities are distributed across different departments, such as the Department of Banking Supervision, to ensure comprehensive oversight of the entire Indian financial landscape and institutional health.

9. (B) 1974
The Basel Committee on Banking Supervision was established in 1974 by the central bank governors of the Group of Ten countries. Formed in response to significant disruptions in international financial markets, its primary goal is to enhance financial stability by improving the quality of banking supervision worldwide through the development of standardized regulatory guidelines and global best practices.

10. (C) Herding behavior
Herding behavior occurs when individuals mimic the actions of a larger group rather than relying on private information. In banking, seeing a run on one institution can cause depositors at healthy, unrelated banks to panic and withdraw funds. This irrational reaction stems from information asymmetry and fear, leading to widespread systemic instability and the potential collapse of healthy institutions.

11. (B) (I), (III), and (IV)
The Basel I framework introduced a common method for assessing capital based on the riskiness of various exposures. Assets were assigned specific risk weights rather than being treated equally. For instance, claims on multilateral development banks typically carried a twenty percent risk weight. This differentiated approach allowed regulators to ensure banks held adequate capital relative to their specific risk profiles.

12. (C) Efficiency and competition depend on the number of banks, entry freedom, and the ability to achieve proper size.
An efficient and competitive financial system is characterized by the presence of numerous participants, the freedom for new firms to enter the market, and the ability of institutions to achieve an optimal operational size. Such a system promotes innovation and better pricing for consumers while maintaining stability through balanced regulation that does not place banks at an unfair competitive disadvantage.

13. (D) Assertion (A) is false, but Reason (R) is true.
Modern banking reforms aim to increase operational autonomy and competition, which necessitates strengthening rather than weakening supervision. Robust oversight is essential to ensure that increased freedom does not lead to excessive risk-taking. Strong supervision protects the system's sustainability and safeguards consumer interests by ensuring that banks remain resilient while operating in a more competitive and dynamic market environment.

14. (C) (I) and (III) only
Banking regulation encompasses the rules for entry, ownership, and activities, while supervision involves monitoring and enforcement. Basel II enhanced this by introducing the Supervisory Review Process, which emphasized institutionalized oversight and risk management. Supervision is not about creating new parliamentary laws but rather ensuring compliance with existing regulations through active monitoring of the banking sector's health, safety, and operational standards.

15. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The collapse of Herstatt Bank illustrates "Herstatt risk," a type of settlement risk arising from time zone differences. Because German regulators closed the bank at the end of the business day, counterparties in New York who had already paid German marks were unable to receive their US dollars. This event

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ANSWERS

1. (D) Contagion arises because liquidated bank assets usually appreciate in value quickly once a bank run begins.
Contagion in banking occurs when the failure of one institution triggers widespread panic. Banks typically transform liquid deposits into illiquid assets. During a run, forced liquidation of these assets usually leads to fire sales, causing asset values to plummet rather than appreciate. This depreciation further weakens balance sheets, exacerbating systemic instability and fueling herding behaviors among worried depositors.

2. (C) To prevent a race to the bottom where jurisdictions lower prudential rules to attract foreign financial firms.
International standards are essential for maintaining a level playing field in global finance. By establishing uniform prudential rules, organizations like the Basel Committee prevent jurisdictions from lowering regulatory requirements to attract foreign firms. This collaborative approach ensures that all participating banks maintain adequate capital buffers, thereby reducing systemic risk and preventing competitive deregulation that could compromise global financial stability.

3. (C) Depositors act as creditors, making it costly to assess bank health using complex, confidential data.
Depositors occupy a unique position as creditors because they lack easy access to a bank's internal financial health. Evaluating a bank requires analyzing complex and often confidential data regarding its loan portfolio and risk exposures. This information asymmetry makes it extremely difficult and costly for individual depositors to monitor institutional safety, necessitating robust external regulation and supervision by authorities.

4. (C) The Concordat
The 1975 Concordat was the foundational document issued by the Basel Committee to address gaps in international supervisory coverage. It established principles for sharing responsibility between home and host country regulators. This ensured that no foreign banking establishment, whether a branch or subsidiary, would escape effective supervision, thereby strengthening the oversight of the rapidly expanding and interconnected global banking network.

NODIA

5. (B) Negative externalities
Negative externalities occur when the actions of a single firm impose significant costs on third parties or society. In banking, excessive risk-taking can lead to systemic failures that require public intervention. While banks may keep short-term profits, the resulting losses and bailouts are often funded by taxpayers, highlighting a misalignment where private gains lead to socialized financial risks.

6. (C) 60%
The abrupt closure of Herstatt Bank in 1974 had an immediate and severe impact on the global financial system. Due to the failure of settlement processes, the gross amount of funds transferred among banks for payments plummeted by sixty percent within just three days. This event underscored the extreme interconnectedness of international banks and the potential for rapid systemic contagion.

7. (B) The rules governing bank establishment, ownership, capital, and permitted activities.
Bank regulation consists of the formal legal framework and administrative rules that govern the establishment, ownership, and permissible activities of financial institutions. It defines mandatory capital requirements and sets boundaries for operations to ensure safety and soundness. By establishing clear standards for entry and conduct, regulation aims to protect depositors and maintain the stability of the overall financial market.

8. (B) Financial Institutions Division (FID) - Responsible exclusively for the supervision

(B) Supplementary Capital (Tier II) includes Subordinated Term Debt with a maturity of more than 5 years.
(C) Asset Revaluation Reserves are strictly classified as part of Core Capital (Tier I).
(D) Goodwill is explicitly identified as an item meant for deduction from the overall capital base.

May/June 2016

43. Which of the following was a landmark feature introduced by the 1996 Amendment to the Capital Accord regarding the treatment of market risk?
(A) It mandated a fixed, non-negotiable 50% capital charge on all equity investments regardless of prevailing market conditions.
(B) It let banks use internal value-at-risk models as a valid basis for measuring market risk capital requirements.
(C) It systematically eliminated Tier 1 and Tier 2 capital, replacing them entirely with Tier 3 capital for all bank operations.
(D) It explicitly excluded commodity price risk and foreign exchange currency risk from its regulatory purview.

Oct/Nov 2009

44. Which of the following statements is true regarding the broader global implementation of the Basel I Accord?
(A) It was exclusively adopted by the G-10 countries, and all emerging market economies formally rejected it.
(B) The RBI explicitly refused to implement Basel I standards, citing severe incompatibility with the Indian market structure.
(C) It resulted in a permanent global reduction of the capital adequacy target to an absolute minimum of 4%.
(D) By 1999, nearly all countries had implemented the Basel Accord, at least on paper.

May/June 2023

45. Under Pillar 1 of the Basel II framework, banks are strictly required to hold total capital equivalent to at least what percentage of their risk-weighted assets?
(A) 6%
(B) 8%
(C) 9%
(D) 10%

Oct/Nov 2018

46. Which of the following correctly pairs the financial asset with its prescribed Basel-I risk weight?
(A) Claims on multilateral development banks - 0% Risk Weight
(B) Cash items in the process of collection - 20% Risk Weight
(C) Claims on the private sector - 50% Risk Weight
(D) Real estate and other investments - 50% Risk Weight

May/June 2007

47. Read the following statements about the Basel II framework:
I The comprehensive version of the Revised Framework was issued in June 2006 incorporating the constituents of capital and the 1996 amendment to incorporate Market Risk.
II In India, the final Basel II guidelines were formally issued by the RBI on April 27, 2007.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2025

48. Consider the following statements about the computation of capital deductions under the Basel framework:
I Investments in unconsolidated banking and financial subsidiary companies must be deducted.
II Investments in the capital of other banks and financial institutions must be deducted.
III General loan-loss provisions must be deducted directly from Tier I capital.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

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highlighted the dangerous interdependence of global banks and spurred the creation of the Basel Committee.

16. (A) Assessing bank asset values is a simple and cost-effective process for most depositors.
Assessing bank asset values is not a simple and cost-effective process for most depositors. Assessing the true value of a bank's assets is a complex and difficult task for most depositors. Much of the information required to evaluate a bank's financial health is confidential or highly technical. Because depositors act as creditors, their financial safety is directly linked to the bank's performance, making independent and accurate assessment nearly impossible for most ordinary customers.

17. (A) As broad supervisory standards and best practices implemented through detailed domestic arrangements.
The Basel Committee on Banking Supervision does not possess formal legal authority or the power to create international laws. Instead, it formulates broad supervisory standards and guidelines. National authorities are expected to implement these recommendations through their own domestic legal and regulatory frameworks, tailoring the standards to suit their specific national interests and unique financial market structures and needs.

18. (A) Financial service disruption from system impairment, causing serious real economy damage.
Systemic risk refers to the potential for a localized financial disruption to trigger widespread instability across the entire financial system. Such impairment can severely impact the real economy by interrupting essential transaction flows and credit availability. This risk highlights the necessity of regulation to prevent individual bank failures from cascading into broader economic crises that harm society at large.

19. (B) (I), (II), and (IV)
Established in 1930 in Basel, Switzerland, the Bank for International Settlements serves as a central hub for international financial cooperation. It acts as a prime counterparty for central banks and is a leading center for economic research. Crucially, the BIS does not have legal supervisory authority over member banks; it functions primarily as a facilitator for global financial stability.

20. (A) P-2, Q-3, R-1, S-4
Regulatory frameworks serve multiple objectives: consumer protection ensures fair access and disclosure, while financial stability prevents business fluctuations from halting transaction flows. Competitive systems rely on market entry and preventing collusion. Finally, supervision involves active monitoring and the enforcement of rules through penalties. Aligning these mechanisms ensures a robust financial environment that balances safety, efficiency, and fairness for all participants.

21. (C) The regulatory focus was primarily directed toward operational and market risk.
The 1988 Basel I Accord primarily focused on credit risk rather than operational or market risks. It was designed to establish minimum capital standards for internationally active banks, aiming to ensure they held sufficient capital against their risk-weighted assets. Effective by 1992, the framework sought to prevent banks from expanding their business volumes without maintaining adequate capital buffers.

22. (C) Both (I) and (II)
Consumer protection legislation in the banking sector focuses on two main areas: transparency and equality. Requiring the disclosure of deposit and credit terms enables customers to make informed comparisons between different financial products. Simultaneously, ensuring equal treatment aims to provide all customers with fair access to credit, regardless of their background, fostering a more equitable and inclusive financial system.

23. (D) Large financial institutions bear all absolute risks and potential losses of their complex portfolios.
Large financial institutions often do not bear all the risks of their portfolios because their failure can have catastrophic effects on the broader economy. When these institutions face distress, the resulting systemic danger often leads to government bailouts. These interventions mean

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exposure at default, remain determined by the supervisor. This approach offers a middle ground between the rigid Standardised Approach and the more complex Advanced Measurement Approach for calculating credit risk.

58. (C) ₹ 4000 million
Total Risk Weighted Assets are calculated by multiplying each asset by its Basel I weight: cash and government bonds carry zero percent, mortgage loans carry fifty percent, and corporate loans carry one hundred percent. Summing these results in total risk-weighted assets of four thousand million rupees. This calculation focuses on the credit risk exposure relative to the nature of each borrower.

59. (A) (I) and (II) only
Tier 3 capital was introduced as short-term subordinated debt with a minimum two-year maturity, designed exclusively to cover market risk charges. Crucially, the repayment of principal must be deferred if it would cause the bank to fall below the minimum capital requirement. This lock-in clause ensures that the capital remains available to absorb losses when the bank's overall financial health is vulnerable.

60. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The simple and broad risk weights of Basel I allowed sophisticated banks to engage in "cherry picking." By securitizing and selling off their lowest-risk corporate loans, which still carried high regulatory weights, banks could reduce their required capital without significantly reducing their actual risk exposure. This mismatch between regulatory capital and economic risk was a key weakness Basel II aimed to resolve.

61. (A) (II), (IV), (III), (I)
The Reserve Bank of India's journey with Basel III began with draft guidelines in late 2011, followed by a formal announcement to adopt stricter measures. In early 2014, the implementation timeline was revised to March 31, 2019. Finally, in March 2016, the RBI allowed banks to include property values in their capital base to help meet these more stringent international standards.

62. (A) To improve risk management by enabling market participants to reward well-managed banks through increased transparency.
Pillar 3, or Market Discipline, aims to harness market forces to encourage sound banking practices. By requiring banks to disclose detailed information about their risk profiles and capital adequacy, it enables market participants to make informed decisions. This transparency allows investors and depositors to reward well-managed institutions, thereby creating a strong external incentive for banks to maintain high risk management standards.

63. (C) Supervisors must ensure banks never hold capital exceeding minimum ratios to avoid potential regional economic stagnation.
The Supervisory Review Process actually encourages banks to hold capital in excess of the minimum regulatory requirements. Pillar 2 principles state that banks must have internal processes to assess their own capital needs and that supervisors must review these assessments. Regulators are expected to intervene early and can mandate higher capital levels if a bank's specific risk profile warrants additional protection.

NODIA

64. (C) Systemic risk - Widespread disruption to financial services that could significantly damage the real economy.
Systemic risk is accurately defined as the danger that a disruption in financial services, caused by an impairment of the financial system, will have serious negative consequences for the real economy. This differs from negative externalities, which involve social costs from private transactions, or banking supervision, which involves monitoring compliance rather than drafting laws. Basel I did not introduce Pillars 2 and 3.

65. (C) Quarterly
For internationally active and highly interconnected financial institutions, standard Pillar 3 guidelines emphasize the importance of timely transparency. To provide market participants with up-to-date information on a bank's risk exposure and capital

amount by the eight percent requirement yields a minimum capital obligation of forty million rupees for that specific exposure.

32. (B) Baring Brothers
The collapse of Baring Brothers in 1995 was a landmark event caused by severe internal control failures. A single trader in the Singapore subsidiary managed to hide massive losses in a secret account because he controlled both the trading and settlement processes. This lack of oversight and separation of duties eventually led to the downfall of one of Britain's oldest merchant banks.

33. (B) P-3, Q-1, R-4, S-2
Basel I assigned specific risk weights to various assets: OECD central government claims carried a zero percent weight, while claims on non-OECD banks with long-term maturities were weighted at one hundred percent. OECD bank claims typically received a twenty percent weight. Domestic public sector entities were weighted at national discretion, reflecting varying risk profiles across different types of sovereign exposures.

34. (D) P-4, Q-2, R-3, S-1
Basel II Pillar 1 offers various methods for calculating capital: the Advanced Measurement Approach for operational risk and the Foundation Internal Ratings-Based approach for credit risk. Operational risk can also be measured using the Basic Indicator Approach. For market risk, banks may use internal models. These options allow institutions to adopt more sophisticated risk assessment techniques as their internal capabilities evolve.

35. (B) 9 per cent
Following the international adoption of the Basel I Accord, the Reserve Bank of India announced its own implementation plan. In the 1998-99 Mid-term Review of Monetary and Credit Policy, the RBI decided to set a higher standard than the international minimum by raising the required Capital to Risk-weighted Assets Ratio from eight percent to nine percent for Indian banks.

36. (A) Basic Indicator Approach
Within the Pillar 1 framework of Basel II, the Basic Indicator Approach is specifically designed to measure operational risk capital requirements. Unlike other methods that might apply to credit or market risks, this approach calculates a capital charge based on a fixed percentage of the bank's positive annual gross income over the previous three years as a proxy for operational exposure.

37. (B) (II) and (IV)
Under Basel I, assets considered virtually risk-free carry a zero percent risk weight. These primarily include claims on central governments denominated in the national currency and claims collateralized by cash or OECD government securities. This classification reflects the high level of safety associated with sovereign debt and cash-backed instruments compared to other commercial or property-related banking assets.

38. (D) The risk that market price changes cause losses in trading positions, both on- and off-balance sheet.
The 1996 Amendment to the Capital Accord formally defined market risk as the potential for losses in a bank's trading positions due to fluctuations in market prices. This encompasses risks related to interest rates, equity prices, foreign exchange, and commodity prices. It applies to both on-balance sheet and off-balance sheet items within the bank's trading book, requiring dedicated capital charges.

39. (D) Pillar 1 - Supervisory Intervention and Solvency Reports
The three pillars of Basel II are clearly defined: Pillar 1 focuses on Minimum Capital Requirements, Pillar 2 on the Supervisory Review Process, and Pillar 3 on Market Discipline. Supervisory intervention and solvency reports are core components of Pillar 2, which ensures that banks have adequate internal processes and that supervisors take timely action to maintain institutional health.

40. (A) Tier-I: ₹ 3000 million, Total Capital: ₹ 4000 million
Tier-I capital consists of equity and disclosed reserves, which for Gamma Bank totals three thousand million rupees. Total capital is the

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sum of Tier-I and Tier-II components, including subordinated debts and general loan loss reserves. Adding these eight hundred million and two hundred million rupee items to the Tier-I amount results in a total capital figure of four thousand million rupees.

41. (B) Intervene early to prevent capital from falling below minimum levels and require rapid, necessary remedial action.
Principle 4 of the Supervisory Review Process mandates that regulators must take proactive and early action when a bank's capital levels begin to decline. Rather than waiting for a complete breach of minimum limits, supervisors are expected to intervene to require remedial measures. This early intervention is crucial for maintaining the safety of the banking system and protecting depositors' interests effectively.

42. (C) Asset Revaluation Reserves are strictly classified as part of Core Capital (Tier I).
Under the Cooke Ratio framework, Asset Revaluation Reserves are not classified as part of Core Capital (Tier I). Instead, they are included in Supplementary Capital (Tier II). Tier I is reserved for the highest quality capital, such as paid-up share capital and disclosed reserves. Tier II includes items like subordinated term debt that have lower loss-absorption capacity than core equity.

43. (B) It let banks use internal value-at-risk models as a valid basis for measuring market risk capital requirements.
A significant development in the 1996 Amendment was the permission for banks to use their own internal value-at-risk models to determine capital requirements for market risk. This shift allowed for more sophisticated risk measurement that aligned with the bank's actual trading activities and internal risk management practices, provided the models met stringent regulatory standards and received supervisory approval.

44. (D) By 1999, nearly all countries had implemented the Basel Accord, at least on paper.
Although originally intended for internationally active banks in G-10 countries, the Basel I Accord gained widespread global acceptance. By 1999, virtually every country with a significant banking sector had implemented its standards, at least on paper. This universal adoption established a global benchmark for capital adequacy, even as many emerging markets like India applied even stricter versions of the rules.

NODIA

45. (B) 8%
Under Pillar 1 of the Basel II framework, the minimum total capital ratio remains consistent with the previous standard at eight percent of risk-weighted assets. This capital covers three main risk types: credit, market, and operational. National regulators often choose to set higher local requirements than this international minimum to ensure greater institutional resilience and overall financial stability.

46. (B) Cash items in the process of collection - 20% Risk Weight
Basel I assigned specific risk weights to different financial assets to reflect their relative safety. Cash items in the process of collection are assigned a twenty percent risk weight. This is higher than the zero percent assigned to direct government claims but significantly lower than the one hundred percent weight typical for private sector corporate loans or uncollateralized commercial investments.

47. (C) Both (I) and (II)
The evolution of Basel II culminated in the 2006 comprehensive version, which integrated the constituents of capital with market risk amendments. In India, the Reserve Bank of India played a proactive role in aligning domestic regulation with international standards, formally issuing final guidelines for Basel II implementation on April 27, 2007, to enhance the risk management of the Indian banking sector.

48. (A) (I) and (II) only
Under the Basel framework, specific items must be deducted from the capital base to ensure the quality of regulatory capital. These include investments in unconsolidated banking and financial subsidiaries, as well as investments in the capital of other financial institutions. Such deductions prevent the double-counting of capital within the financial system, ensuring a more accurate measure of institutional health.

49. (A) The early regulatory shutdown by German authorities before the New York financial markets opened.
The failure of Barings Bank was primarily caused by internal failures, not external regulatory actions from Germany. Key factors included the lack of separation between trading and settlement duties, the use of fraudulent entries in a secret account to hide mounting losses, and the submission of falsified reports. The Herstatt Bank failure, rather than Barings, involved the German regulatory shutdown at the end of their banking day.

50. (C) Cherry picking
Cherry picking refers to a form of regulatory arbitrage where banks use securitization to remove low-risk assets from their balance sheets while retaining high-risk, unrated tranches. This practice allows banks to lower their capital requirements under simple risk-weighting rules without actually reducing their total risk exposure. This was a major criticism of Basel I, as it distorted a bank's true risk profile.

51. (D) Supervisors should expect banks to hold capital above the minimum and have the power to require extra capital if necessary.
Principle 3 of the Supervisory Review Process empowers regulators to expect banks to maintain capital levels exceeding the statutory minimums. Supervisors are granted authority to require additional capital buffers if a bank's specific risk profile or internal assessment suggests that the minimum requirement is insufficient. This ensures a higher level of safety tailored to the individual circumstances of each financial institution.

52. (D) $\text{Cooke Ratio} = \dfrac{\text{Capital}}{\text{RiskWeightedAssets}} \geq 8$
The Cooke Ratio, established by the Basel Committee, is the standard formula for measuring a bank's capital adequacy. It is calculated by dividing the total eligible capital by the sum of risk-weighted assets. The target standard ratio is set at a minimum of eight percent, ensuring that banks have a sufficient financial buffer to absorb potential losses relative to their risks.

53. (A) 12.5%, Yes it meets the requirement.
To calculate the ratio, the total capital of five hundred million rupees is divided by the four thousand million rupees of risk-weighted assets. This results in a ratio of 12.5 percent. Since this value exceeds the eight percent minimum requirement established by the Cooke Ratio, the bank successfully meets the regulatory capital standard for safety and institutional soundness.

54. (C) Increased internal modeling showed that Basel I risk weights perfectly matched banks' best estimates of actual risk.
A primary driver for Basel II was the realization that the simple risk weights of Basel I did not perfectly match banks' internal estimates of actual risk. Sophisticated internal modeling often showed significant discrepancies, leading to regulatory arbitrage. Basel II was developed to address these flaws by creating more sensitive risk measures and formally recognizing operational risk as a new requirement.

55. (C) Tier 3 Capital
The 1996 Market Risk Amendment introduced Tier 3 capital specifically to help banks meet capital charges related to market risk. This category consists of short-term subordinated debt with an original maturity of at least two years, although it must be capable of being deferred if the bank's capital falls below minimum requirements. This provides a flexible capital tool for trading activities.

56. (B) Only (II)
Under the Basel I framework, risk weighting for public sector entities varied. While claims on commercial companies owned by the public sector were assigned a standard one hundred percent risk weight, weights for other domestic public sector entities were not globally rigid. Instead, these were often left to national discretion, allowing regulators to account for the specific creditworthiness of various governmental bodies.

57. (A) Foundation IRB Approach
The Foundation Internal Ratings-Based approach allows banks to use their own internal estimates for specific risk components, such as the probability of default. However, other parameters, including loss given default and

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CHAPTER 24

Global Financial Crisis and Basel III

May/June 2021

1. The Basel Committee recommended a countercyclical buffer comprising common equity within what specific range?
(A) 0% to 2.0%
(B) 0% to 2.5%
(C) 2.5% to 4.5%
(D) 4.5% to 7.0%

Oct/Nov 2007

2. Which of the following is an incorrect statement regarding the liquidity standards introduced by the Basel Committee?
(A) The Liquidity Coverage Ratio (LCR) requires banks to maintain a sufficient stock of high-quality liquid assets.
(B) The LCR is strictly intended to withstand a highly specific stressed funding scenario as specified by supervisors.
(C) The NSFR targets short-term structural liquidity mismatches specifically over a 30-day period.
(D) The NSFR provides long-term structural incentives for banks to fund their activities with reliable sources of funding.

May/June 2013

3. What is a debt instrument secured by a pool of mortgages, whether residential or commercial?
(A) Repurchase agreement
(B) Countercyclical capital instrument
(C) Mortgage-backed security
(D) Leveraged buyout bond

Oct/Nov 2023

4. What is the most appropriate reason for the introduction of a non-risk-based leverage ratio in the Basel III framework?
(A) Effectively eliminating the requirement for individual banks to hold any significant common equity.
(B) Providing incentives for banks to participate more heavily in unregulated shadow banking activities.
(C) Serving as a backstop to risk-based requirements and containing excessive leverage build-up.
(D) Effectively replacing the Net Stable Funding Ratio (NSFR) for managing long-term structural mismatches.

NODIA

May/June 2005

5. What does maturity transformation entail in the context of financial intermediaries?
(A) Utilizing long-term shareholder capital to fund short-term overnight loans to other institutions.
(B) Raising short-term funds in money markets and using them to buy assets with longer-term maturities.
(C) Transforming physical branch networks into digital platforms to increase operational efficiency.
(D) Systematically replacing Tier 2 capital instruments with higher-quality common equity shares.

Oct/Nov 2015

6. What is the primary goal of imposing a countercyclical buffer within a range of 0% to 2.5%?
(A) To force banks to liquidate assets during an economic downturn.
(B) Mitigating procyclicality by retaining earnings in boom times to support operations during stress.
(C) Establishing permanent freezes on the discretionary distributions made by systemically important banks.
(D) Replacing the minimum requirement for common equity entirely.

May/June 2018

7. What refers to the credit quality of particular borrowers who have weakened credit histories and a greater risk of loan default than prime borrowers?
(A) Corporate grade loan
(B) Sub-prime loan

adequacy, quarterly disclosures are generally recommended. This frequency ensures that any significant changes in the bank's risk profile are communicated promptly to the public and market participants.

66. (B) P-2, Q-3, R-1, S-4
The Basel framework components serve distinct roles: Pillar 1 calculates risk-weighted assets for credit risk, while Pillar 2 involves solvency reports and regulatory intervention. Pillar 3 focuses on capital transparency and disclosure. Additionally, the 1996 Amendment introduced the use of value-at-risk models for market risk. Together, these elements form a comprehensive approach to managing and monitoring risk within the global system.

67. (A) (II), (IV), (I), (III)
The sequence of major regulatory milestones begins with the 1974 collapse of Herstatt Bank, which led to the 1988 release of the original Basel I Accord. Subsequently, the Reserve Bank of India established the Board for Financial Supervision in 1994 to enhance domestic oversight. This was followed by the international release of the Market Risk Amendment to the Capital Accord in 1996.

68. (D) (I), (II), (III), (IV), and (V)
The Reserve Bank of India has followed a structured timeline for implementing Basel standards, starting with raising the CRAR in 1998 and issuing Basel II guidelines in 2007. The process continued with Basel III draft guidelines in 2011, a timeline revision in 2014, and an expansion of the capital base definition in 2016. These steps demonstrate India's commitment to international prudential standards.

69. (D) (I), (II), (III), and (IV)
Under Pillar 3, banks are required to disclose a comprehensive range of information to ensure market discipline. This includes their specific risk exposures, the adequacy of their capital, and the precise methods used to compute capital requirements. Furthermore, any material information that could influence the decision-making of market agents must be disclosed, fostering an environment of transparency and informed financial participation.

70. (D) (I), (II), (III), (IV), and (V)
Banking regulation is a multi-faceted endeavor aimed at protecting depositors, maintaining financial stability, and ensuring transaction flows. Globally, the Basel Committee provides the benchmark standards, while documents like the Concordat define international supervisory responsibilities. The three-pillar approach of Basel II represents a comprehensive framework for identifying, measuring, and monitoring the diverse risks faced by modern financial institutions in a globalized economy.

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May/June 2022

15. What is the most appropriate description of "procyclicality" in the context of leverage?
(A) Leverage remains constant regardless of economic conditions.
(B) Leverage decreases during economic booms to build a capital conservation buffer.
(C) Leverage is strictly regulated by countercyclical buffer requirements to always move opposite to the economy.
(D) Leverage rises in good times when confidence is high and falls in bad times when confidence turns to caution.

Oct/Nov 2005

16. What is the term used to describe purchasing a revenue-generating asset and quickly reselling it for profit?
(A) House flipping
(B) Securitization
(C) Macro-hedging
(D) Maturity transformation

May/June 2010

17. Improvement in market discipline requires enhanced disclosure of information on all of the following, EXCEPT:
(A) Daily transaction histories of individual retail depositors
(B) Off-balance sheet commitments
(C) Firms' liquidity profiles
(D) Risk exposures and concentrations within and between financial institutions

Oct/Nov 2019

18. Which economist coined the term "shadow bank" in a 2007 speech at the annual financial symposium hosted by the Kansas City Federal Reserve Bank?
(A) Paul McCulley
(B) Ben Bernanke
(C) Alan Greenspan
(D) Milton Friedman

May/June 2014

19. Which of the following is an incorrect statement regarding Systemically Important Banks (SIBs)?
(A) Excessive interconnectedness among SIBs transmitted shocks across the financial system and the broader economy.
(B) SIBs are generally required to have loss absorbing capacity that goes beyond the standard minimum requirements.
(C) The Basel committee recommended higher capital requirements to be maintained by all institutions identified as SIBs.
(D) SIBs are recommended to maintain capital requirements strictly identical to smaller, non-systemic banks.

Oct/Nov 2006

20. Which of the following statements is correct regarding the macroeconomic environment leading up to the Global Financial Crisis?
(A) Economic conditions were favorable, with strong growth and expectations that house prices would continue to rise.
(B) Economic growth was historically volatile, and rates of inflation and unemployment were considered extremely high.
(C) High interest rates strongly discouraged domestic households from borrowing to purchase residential houses.
(D) The macroeconomic environment forced central banks to enforce strict mandatory countercyclical capital buffers.

May/June 2023

21. Arrange the following events in the correct chronological sequence leading to the Global Financial Crisis:
1. Favorable economic conditions and expectations of rising house prices led to imprudent borrowing.
2. Banks and investors borrowed increasing amounts to expand lending and purchase mortgage-backed securities.
3. Default rates in mortgage loans began to climb up in banks' credit portfolios.
4. House prices declined and the equity of homeowners was quickly wiped out.

(A) 1, 2, 4, 3
(B) 1, 4, 2, 3
(C) 2, 1, 4, 3
(D) 2, 4, 1, 3

NODIA

Oct/Nov 2014

22. Under Basel III, what is the new minimum requirement for common equity after the application of stricter adjustments?
(A) 2.0%
(B) 2.5%
(C) 4.5%
(D) 7.0%

(C) Syndicated loan
(D) Wholesale funding loan

Oct/Nov 2009

8. What is the primary function of the capital conservation buffer introduced in the new regulatory capital framework?
(A) To finance the acquisition of shadow banks during an economic boom.
(B) To absorb losses during periods of financial and economic stress.
(C) To replace the risk-based leverage ratio for trading activities.
(D) To ensure foreign intermediaries have sufficient US dollar funding.

May/June 2024

9. The crisis revealed significant defects in risk management and risk controls. These defects included all of the following, EXCEPT:
(A) A significant and observable deterioration of mortgage underwriting standards across the entire financial industry.
(B) An excessive reliance on internal bank qualitative assessments rather than rating agencies for asset-backed securities.
(C) The poor management of concentration risk and other institutional risks by individual mortgage lenders.
(D) The extension of the traditional originate-to-distribute business model to complex securitized credit products.

Oct/Nov 2011

10. How does an increase in leverage impact a financial investment?
(A) It reduces both potential profits and potential losses.
(B) It magnifies potential profits but reduces potential losses.
(C) It magnifies both potential profits and potential losses.
(D) It stabilizes the equity portion against market fluctuations.

May/June 2008

11. Arrange the following events representing the cascading impact of the financial crisis in the correct chronological sequence:
1. Major U.S. financial firms like Lehman Brothers failed.
2. Mortgage-backed security (MBS) prices declined, which reduced the value of MBS and the net worth of MBS investors.
3. Investors began pulling their money out of banks and investment funds around the world.
4. Lenders repossessed houses and found they could only be sold at prices below the loan balance.

(A) 4, 2, 1, 3
(B) 2, 4, 1, 3
(C) 4, 1, 2, 3
(D) 2, 1, 4, 3

Oct/Nov 2022

12. The Global Financial Crisis refers to the period of extreme stress in global financial markets and banking systems between which years?
(A) Mid 2005 and early 2007
(B) Mid 2007 and early 2009
(C) Late 2008 and early 2010
(D) Mid 2009 and late 2011

May/June 2015

13. Which of the following is an incorrect statement regarding the macro-prudential regulatory framework prior to the reforms?
(A) Current prudential approaches successfully prevented the build-up of systemic risk.
(B) Current regulatory tools failed to dampen the procyclicality of financial markets.
(C) Existing regulations aggravated economic downturns.
(D) Existing regulations required banks to hold more capital in downturns.

NODIA

Oct/Nov 2017

14. Which of the following statements correctly describes the regulatory perimeter reform required after the Global Financial Crisis?
(A) Narrowing the regulatory perimeter to focus exclusively on systemic commercial banking entities.
(B) Requiring the immediate integration of all shadow banks into the traditional commercial banking system.
(C) Broadening the perimeter to ensure all systemic financial activities are adequately captured.
(D) Limiting the scope of the perimeter to the internal audit functions of private mortgage companies.

that the immense costs of failure are shifted to taxpayers and society, creating a significant negative externality.

24. (D) It sets broad supervisory standards for local authorities to implement via arrangements suited to national interests.
The Basel Committee on Banking Supervision does not have any sovereign or legal authority to enforce its recommendations. Its primary role is to develop broad supervisory standards and best practices. Member countries are encouraged to adopt these standards by incorporating them into their own national regulatory frameworks through specific legal arrangements that align with their local economic conditions.

25. (B) Section 35A of the Banking Regulation Act, 1949
Under Section 35A of the Banking Regulation Act, 1949, the Reserve Bank of India is empowered to issue directions to banking companies in the public interest. This statutory provision allows the regulator to intervene when a bank's operations are conducted in a manner prejudicial to the interests of depositors or the overall stability of the banking system.

26. (D) By building strong, liquid banks and discouraging practices that harm depositors and payment systems.
Banking regulation promotes monetary and financial stability by requiring banks to maintain adequate liquidity and capital. By discouraging risky practices that could harm depositors or disrupt payment systems, regulators ensure that the financial infrastructure remains resilient. This oversight helps maintain public confidence in the currency and the overall economy by preventing widespread disruptions in essential financial transactions.

27. (A) P-1, Q-4, R-2, S-3
Key milestones in international banking supervision include the first Concordat in 1975 and its revision into broader principles in 1983. The seminal Basel I Accord was released in 1988 to standardize capital requirements. Subsequently, in 1990, a supplement was issued to facilitate the exchange of information between global supervisors, further strengthening the framework for international regulatory cooperation.

28. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Government guarantees can distort management incentives by creating a moral hazard. Because these guarantees protect against total loss, bank managers may pursue riskier investments to maximize private profits. They understand that while successful risks yield high returns for the bank, catastrophic losses will likely be socialized through public bailouts, encouraging behavior that compromises long-term financial stability.

29. (C) To prevent fragmented frameworks that hinder trust, split capital pools, and increase systemic risks.
The creation of international standards-setting bodies like the Basel Committee is driven by the need to harmonize global financial regulation. Fragmented national frameworks can lead to regulatory arbitrage, split capital pools, and diminished trust between jurisdictions. By establishing uniform standards, these bodies help reduce systemic risks and ensure a more stable, interconnected global financial system that functions consistently.

30. (D) To incentivize rule compliance, as regulations lack practical effect without oversight and penalties.
Statutory regulations often lack practical effectiveness if there is no mechanism for monitoring and enforcement. Supervisory discipline provides the necessary oversight to ensure that banks adhere to established rules. By imposing penalties for non-compliance, regulators create a strong incentive for banks to maintain safety and soundness, ensuring that regulatory standards translate into actual stable behavior within the banking system.

31. (B) ₹ 40 million
Under the Basel I framework and the Cooke Ratio, the minimum capital requirement is eight percent of risk-weighted assets. A five hundred million rupee loan with a one hundred percent risk weight results in risk-weighted assets of five hundred million. Multiplying this

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May/June 2007

23. How can vulnerability to liquidity shocks turn into solvency problems for an individual institution?

(A) The institution holds excess common equity that cannot be distributed to its primary shareholders.

(B) The institution is forced by regulators to increase its countercyclical buffer during a sharp downturn.

(C) The institution shifts entirely to retail deposits, which increases its long-term deposit insurance costs.

(D) The institution cannot rely on market funding during stress, forcing fire-sale of assets.

Oct/Nov 2025

24. The reform and redesigning of the regulatory framework covered five major areas. Which of the following is NOT one of these areas?

(A) Broadening the regulatory perimeter

(B) Improving micro-prudential regulation

(C) Implementing countercyclical macro-prudential regulation

(D) Eliminating the shadow banking sector entirely

May/June 2019

25. Which of the following is an incorrect statement regarding the characteristics of subprime borrowers?

(A) They typically demonstrate extremely limited or non-existent prior experience with debt.

(B) They possess ample property assets that can be used as security by the lender.

(C) They frequently carry levels of debt that are considered excessive relative to their annual income.

(D) They often maintain a documented history of late or sometimes entirely missed payments.

Oct/Nov 2016

26. What is the term for financial policies aimed at ensuring the stability of the financial system as a whole to prevent substantial disruptions in credit and other vital financial services?

(A) Micro-prudential

(B) Procyclical

(C) Shadow banking

(D) Macro-prudential

May/June 2011

27. What was the primary mechanism through which the U.S. housing market downturn spilled over to financial systems and economies in other countries?

(A) Foreign banks actively participated in purchasing U.S. mortgage-backed securities using short-term US dollar funding.

(B) The U.S. Federal Reserve restricted foreign banks from accessing domestic retail deposit networks.

(C) Foreign governments provided direct guarantees for U.S. subprime loans through bilateral agreements.

(D) Shadow banking entities were explicitly and strictly regulated by various international monetary bodies.

Oct/Nov 2010

28. Why are shadow banks particularly vulnerable to bank runs?

(A) They rely on short-term uninsured funds and lack access to emergency central bank borrowing.

(B) They are strictly prohibited by statute from engaging in any meaningful maturity transformation.

(C) They utilize a model of long-term insured deposits to fund their diverse portfolio of short-term assets.

(D) They are subjected to excessive central bank oversight which prevents the rapid liquidation of assets.

NODIA

May/June 2025

29. All of the following were reasons lenders were willing to make increasingly large volumes of risky housing loans leading up to the crisis, EXCEPT:

(A) Increased competition between individual lenders to extend ever-larger amounts of housing loans.

(B) A belief that favorable economic conditions and house price increases would continue.

(C) Lenders expected to bear significant long-term losses on their retained loan portfolios.

(D) Lenders sold large amounts of loans to investors in the form of mortgage-backed

a longer-term structural ratio designed to address liquidity mismatches across the entire balance sheet.

Which combination of statements is correct?

(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2014

61. Read the following scenario regarding regulatory review and answer the questions that follow:

Apex Bank operates with heavy reliance on wholesale market funding. During an economic boom, Apex aggressively expanded its balance sheet, increasing its leverage significantly while maintaining its required risk-based capital ratios by investing in assets deemed low risk by rating agencies. The national regulator is conducting a supervisory review and mandates Apex to comply with Basel III's macro-prudential and liquidity measures to ensure it can withstand future systemic shocks.

To prevent Apex Bank from building up excessive leverage while superficially appearing adequately capitalized under risk-based measures, the Basel III framework introduces which specific safeguard to act as a backstop?

(A) Increased reliance on rating agencies' qualitative assessments
(B) An outright ban on the originate-to-distribute business model
(C) A non-risk-based leverage ratio
(D) A prohibition on off-balance sheet transactions

Oct/Nov 2019

62. Read the following scenario regarding a bank's capital assessment and answer the questions that follow:

Global Bank Corp (GBC) is a large, internationally active bank assessing its capital requirements under the newly implemented Basel III framework. Prior to the crisis, GBC displayed strong Tier 1 capital ratios by taking regulatory deductions from Tier 2 capital, leaving its common equity largely intact. Post-crisis, the regulator informs GBC that it must adhere to stricter definitions of capital to ensure true loss-absorbing capacity. GBC's total risk-weighted assets are calculated at ₹100 billion.

To meet the new Basel III minimum requirement for common equity (after the application of stricter adjustments but before factoring in any buffers), how much common equity must GBC hold against its ₹100 billion in risk-weighted assets?

(A) ₹2.0 billion
(B) ₹4.5 billion
(C) ₹7.0 billion
(D) ₹8.0 billion

May/June 2023

63. Read the following scenario regarding a financial entity and answer the questions that follow:

Zenith Capital is a financial entity that acts as an intermediary channeling savings into investments. It is heavily involved in purchasing long-term mortgage securities. To fund these purchases, Zenith relies entirely on short-term uninsured funds raised from the money markets. It operates outside traditional banking supervision, holds no traditional deposits, and lacks access to the Central Bank's emergency lending facilities. In mid-2007, rumors regarding the declining value of Zenith's mortgage securities spread rapidly.

As rumors spread, lenders refuse to roll over Zenith's short-term funds. This scenario exposes Zenith to what specific risk characteristic of such entities?

(A) Imposition of a strict countercyclical capital buffer constraint based on asset price trends.
(B) An automatic government-funded bailout triggered by domestic deposit insurance mechanisms.
(C) A run on the entity, leading to insolvency if assets must be sold at fire-sale prices.
(D) Immediate conversion to a regulated Non-Banking Financial Company with full legal oversight.

Oct/Nov 2008

64. Read the following scenario regarding macro-prudential principles and answer the questions that follow:

During an extended period of stable economic growth, housing prices and loan growth in

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assets are sold at fire-sale prices.

II Shadow banks have traditional depositors whose funds are covered by insurance.

Which of the above statements is/are correct?

(A) Both (I) and (II) are correct
(B) Both (I) and (II) are incorrect
(C) (I) is correct and (II) is incorrect
(D) (I) is incorrect and (II) is correct

Oct/Nov 2021

36. Read the following scenario regarding housing investment and answer the questions that follow:

Pramod is an investor operating during a period of strong economic growth. He identifies a residential property valued at ₹1,00,000. He utilizes ₹10,000 of his own equity and borrows ₹90,000 from a local lender to complete the purchase, planning to quickly resell it for a profit. The lender, driven by intense competition and a belief that favorable conditions will persist, approves the loan without strict underwriting. The lender soon packages this loan with others into a structured debt instrument and sells it to institutional investors.

The lender's practice of originating Pramod's loan primarily to package and sell it as a debt instrument to investors is an example of which of the following vulnerabilities of the financial system?

(A) Extension of the traditional originate-to-distribute business model
(B) Implementation of a countercyclical macro-prudential framework
(C) Deployment of a mandatory capital conservation buffer
(D) Stricter micro-prudential liquidity regulations

May/June 2017

37. Match the Risk/Vulnerability listed in List I with its description or source in List II.

List I: (Risk/Vulnerability)

P. Leverage
Q. Spillovers
R. Procyclicality
S. Solvency Risk

List II: (Description/Source)

1. Transmitted through interconnectedness and cross-border gross positions.
2. Aggravated when confidence turns to caution in bad times.
3. Triggered when vulnerable institutions face sustained liquidity shocks.
4. Magnifies both potential profits and potential losses.

(A) P-4, Q-1, R-2, S-3
(B) P-1, Q-4, R-3, S-2
(C) P-4, Q-2, R-1, S-3
(D) P-3, Q-1, R-2, S-4

Oct/Nov 2012

38. Consider the following statements about the regulatory shortcomings identified post-crisis:

I Current prudential approaches largely failed to prevent the build-up of systemic risk over a favorable economic cycle.
II Existing regulations aggravate economic downturns by requiring banks to hold more capital in downturns as risk measures increase.
III Market discipline had not been sufficiently effective in complementing supervision.
IV Supervisors paid equivalent attention to sound liquidity management practices as they did to solvency risk before the crisis.

Which combination of statements is correct?

(A) (I) and (II) only
(B) (I), (II), and (III) only
(C) (II) and (IV) only
(D) (I), (III), and (IV) only

May/June 2016

39. Read the following assertion and reason and select the correct option:

Assertion (A): During the global financial crisis, foreign banks in Europe quickly experienced spillovers and funding problems.

Reason (R): Foreign banks were active participants in the U.S. housing market boom, including purchasing MBS funded by short-term US dollar borrowings.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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(D) 7.0%

Oct/Nov 2012

68. Read the following scenario regarding regulatory review and answer the questions that follow:

Apex Bank operates with heavy reliance on wholesale market funding. During an economic boom, Apex aggressively expanded its balance sheet, increasing its leverage significantly while maintaining its required risk-based capital ratios by investing in assets deemed low risk by rating agencies. The national regulator is conducting a supervisory review and mandates Apex to comply with Basel III's macro-prudential and liquidity measures to ensure it can withstand future systemic shocks.

To address structural liquidity mismatches across Apex Bank's entire balance sheet over a longer horizon, and to provide incentives to use stable sources of funding, the regulator will mandate compliance with the:

(A) Net stable funding ratio (NSFR)
(B) Non-risk-based leverage ratio
(C) Value-at-Risk (VaR) stressed inputs
(D) Tier 1 gross coverage ratio

May/June 2025

69. Read the following scenario regarding a bank's capital assessment and answer the questions that follow:

Global Bank Corp (GBC) is a large, internationally active bank assessing its capital requirements under the newly implemented Basel III framework. Prior to the crisis, GBC displayed strong Tier 1 capital ratios by taking regulatory deductions from Tier 2 capital, leaving its common equity largely intact. Post-crisis, the regulator informs GBC that it must adhere to stricter definitions of capital to ensure true loss-absorbing capacity. GBC's total risk-weighted assets are calculated at ₹100 billion.

If GBC wishes to avoid any regulatory constraints on its discretionary distributions (such as dividends), what is the total minimum common equity it must hold as a percentage of risk-weighted assets, factoring in the required capital conservation buffer?

(A) 2.5%
(B) 4.5%
(C) 7.0%
(D) 9.5%

Oct/Nov 2010

70. Read the following scenario regarding macro-prudential principles and answer the questions that follow:

During an extended period of stable economic growth, housing prices and loan growth in Country X have diverged substantially from their long-run trends, leading to speculative bubbles. The central bank of Country X, applying Basel III macro-prudential principles, is highly concerned about the procyclicality of the financial system. It decides to enforce measures that require banks to build up additional capital defenses during this boom period, which can then be drawn down when the economic cycle turns downwards.

By forcing banks to plough back profits into this capital buffer during boom times, what adverse effect of the pre-crisis regulations is the central bank primarily trying to prevent during a future downturn?

(A) Mandatory holdings of excessive high-quality liquid assets that could potentially stall domestic economic growth.
(B) Existing rules forcing banks to cut back on lending due to depleted capital as risk measures increase.
(C) Excessive disclosure of sensitive off-balance sheet commitments that might frighten away global institutional investors.
(D) Unregulated shadow banks automatically converting into commercial entities because of a lack of available funds.

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period of strong economic growth. He identifies a residential property valued at ₹1,00,000. He utilizes ₹10,000 of his own equity and borrows ₹90,000 from a local lender to complete the purchase, planning to quickly resell it for a profit. The lender, driven by intense competition and a belief that favorable conditions will persist, approves the loan without strict underwriting. The lender soon packages this loan with others into a structured debt instrument and sells it to institutional investors.

If the housing market experiences a sudden downturn and the property's value falls to ₹90,000, what is the direct impact on Pramod's initial equity?

(A) His equity is reduced to ₹5,000.
(B) His equity remains at ₹10,000 due to limited liability.
(C) He loses all of the ₹10,000 equity he initially had.
(D) He owes the lender an additional ₹10,000 above his equity.

Oct/Nov 2023

46. Match the Basel III Micro-Prudential Reforms in List I with their specific actions in List II.

List I: (Micro-Prudential Reforms)
P. Quality of capital
Q. Containing leverage
R. Risk coverage
S. Liquidity

List II: (Specific Actions)
1. Introduction of LCR and NSFR.
2. Stricter definition of common equity.
3. Introduction of a non-risk-based backstop.
4. Inclusion of complex illiquid credit products and derivative related exposures.

(A) P-3, Q-2, R-4, S-1
(B) P-2, Q-3, R-4, S-1
(C) P-4, Q-1, R-2, S-3
(D) P-2, Q-4, R-1, S-3

May/June 2019

47. Read the following assertion and reason and select the correct option:

Assertion (A): In the lead up to the Global Financial Crisis, existing prudential regulations successfully prevented the build-up of systemic risk and excessive leverage over a favorable economic cycle.

Reason (R): Existing regulations aggravate economic downturns by requiring banks to hold more capital in downturns as risk measures increase.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

NODIA

Oct/Nov 2005

48. Which of the following pairs regarding the sub-prime borrower characteristics is incorrectly matched?

(A) Debt experience - Limited or none
(B) Security possession - Adequate property assets for lenders to sell
(C) Income vs expenses - Unlikely to be enough to pay living expenses plus interest
(D) Repayment history - Late or sometimes missed payments

May/June 2009

49. Consider the following statements regarding Sub-prime borrowers:

I They have a greater risk of loan default than prime borrowers.
II They typically have extensive and proven debt experience.
III They possess limited or no property assets that could be used as security.
IV Their known income is unlikely to be enough to pay living expenses plus interest and repayment.
V They often have a history of late or sometimes missed payments.

Which combination of statements is correct?

(A) (I), (II), (III), and (IV) only
(B) (I), (III), (IV), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (IV), and (V) only

Oct/Nov 2011

50. Consider the following statements regarding the causes of the Global Financial Crisis:

I Regulation of subprime lending and MBS products was too lax.
II Central banks fully recognized the extent

securities.

Oct/Nov 2013

30. Which of the following statements correctly describes the Basel III focus on raising the quality of capital?

(A) Credit losses and write downs must be absorbed primarily by Tier 2 capital instruments and general provisions.

(B) The framework adopted a significantly more relaxed definition of common equity to ensure global compliance.

(C) Tier 1 capital ratios can continue to be displayed without factoring in any significant regulatory deductions.

(D) Deductions are taken from common equity rather than from Tier 1 or Tier 2 capital instruments.

May/June 2012

31. Which of the following pairs correctly aligns the Basel III buffer with its common equity percentage recommendation?

(A) Minimum common equity before regulatory adjustments - 4.5%

(B) Countercyclical buffer - Flat 4.5%

(C) Capital conservation buffer - 2.5%

(D) Total common equity requirement (including conservation buffer) - 10.0%

Oct/Nov 2024

32. Consider the following statements regarding Shadow Banks:

I They are strictly regulated financial institutions like commercial banks.

II They engage in maturity transformation by raising short-term funds to buy longer-term assets.

III They have traditional depositors whose funds are fully covered by insurance.

IV They became heavily dependent on short-term wholesale funding leading up to the crisis.

V Securitization vehicles and money market funds are parts of the shadow banking system.

Which combination of statements is correct?

(A) (II), (IV), and (V) only

(B) (I), (II), and (IV) only

(C) (III), (IV), and (V) only

(D) (II), (III), (IV), and (V) only

May/June 2009

33. Match the macro-prudential and market discipline terms in List I with their characteristics in List II.

List I: (Terms)

P. Countercyclical buffer

Q. Capital conservation buffer

R. Market discipline

S. Systemically important banks

List II: (Characteristics)

1. Requires disclosure of all elements of the regulatory capital base.
2. Ranges from 0% to 2.5% to mitigate procyclicality.
3. Should have loss-absorbing capacity beyond the minimum standards.
4. Comprises 2.5% common equity above the minimum requirement.

(A) P-2, Q-4, R-1, S-3

(B) P-4, Q-2, R-3, S-1

(C) P-2, Q-1, R-4, S-3

(D) P-1, Q-4, R-2, S-3

Oct/Nov 2008

34. Read the following assertion and reason and select the correct option:

Assertion (A): The Basel Committee introduced a non-risk-based leverage ratio as a key element of the Basel III regulatory capital framework.

Reason (R): The supplementary leverage ratio will help contain the build-up of excessive leverage and serve as a safeguard against attempts to "game" the risk-based requirements.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

May/June 2020

35. Evaluate the following statements about shadow banking:

I A run on an individual shadow bank may start with rumors about its solvency, as few entities can remain solvent if their

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(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2017

56. Match the Shadow Banking concept in List I with its correct attribute in List II.
List I: (Shadow Banking Concept)
P. Maturity transformation
Q. Funding source
R. Regulatory status
S. Examples
List II: (Attribute)
1. Securitization vehicles and money market funds.
2. Not subject to traditional bank regulation or central bank emergency borrowing.
3. Using short-term funds in money markets to buy assets with longer-term maturities.
4. Reliance on short-term uninsured wholesale funds.
(A) P-3, Q-4, R-2, S-1
(B) P-4, Q-3, R-1, S-2
(C) P-3, Q-2, R-4, S-1
(D) P-2, Q-4, R-3, S-1

May/June 2015

57. Read the following scenario regarding housing investment and answer the questions that follow:
Pramod is an investor operating during a period of strong economic growth. He identifies a residential property valued at ₹1,00,000. He utilizes ₹10,000 of his own equity and borrows ₹90,000 from a local lender to complete the purchase, planning to quickly resell it for a profit. The lender, driven by intense competition and a belief that favorable conditions will persist, approves the loan without strict underwriting. The lender soon packages this loan with others into a structured debt instrument and sells it to institutional investors.
If the property's value increases to ₹1,10,000, what is the value of Pramod's equity after paying back the principal of the borrowed amount (ignoring interest costs)?
(A) ₹10,000
(B) ₹20,000
(C) ₹1,00,000
(D) ₹1,10,000

Oct/Nov 2025

58. Evaluate the following statements regarding the business model of banks prior to the crisis:
I The traditional originate-to-distribute business model was extended to encompass increasingly complex securitized credit products.
II Banks made themselves less vulnerable by strictly avoiding the use of Rating agencies' ratings for asset-backed securities.
Which of the above statements is/are correct?
(A) Both (I) and (II) are correct
(B) Both (I) and (II) are incorrect
(C) (I) is correct and (II) is incorrect
(D) (I) is incorrect and (II) is correct

May/June 2018

59. Consider the following statements regarding Regulatory reforms and Capital buffers:
I Macro-prudential approaches aim to better dampen the procyclicality of financial markets.
II Existing regulations aggravate economic downturns by forcing banks to hold more capital when risk measures increase.
III Countercyclical capital regulation could alter collateral and provisioning requirements based on long-run asset price trends.
IV As a bank's capital level moves closer to the minimum requirement, the conservation buffer imposes constraints on discretionary distributions.
V A countercyclical buffer range of 2.5% to 5.0% of common equity was recommended.
Which combination of statements is correct?
(A) (I), (II), (III), and (IV) only
(B) (II), (III), (IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (IV), and (V) only

Oct/Nov 2006

60. Consider the following statements about the Liquidity standards introduced in Basel III:
I Strong capital requirements are a necessary and completely sufficient condition for banking sector stability.
II The Liquidity Coverage Ratio (LCR) requires banks to have sufficient high-quality liquid assets to withstand a specified stressed funding scenario.
III The Net Stable Funding Ratio (NSFR) is

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Oct/Nov 2020

40. Which of the following pairs regarding regulatory reform areas is incorrectly matched?
(A) Regulatory perimeter - Broadened to capture off-balance sheet entities
(B) Information and market discipline - Enhances corporate governance practices
(C) Organization of regulation - Greater coordination within and across countries
(D) Micro-prudential regulation - Dampens procyclicality of financial markets

May/June 2006

41. Read the following scenario regarding a financial entity and answer the questions that follow:
Zenith Capital is a financial entity that acts as an intermediary channeling savings into investments. It is heavily involved in purchasing long-term mortgage securities. To fund these purchases, Zenith relies entirely on short-term uninsured funds raised from the money markets. It operates outside traditional banking supervision, holds no traditional deposits, and lacks access to the Central Bank's emergency lending facilities. In mid-2007, rumors regarding the declining value of Zenith's mortgage securities spread rapidly.
Zenith Capital's practice of raising short-term funds in the money markets to buy assets with longer-term maturities is referred to by economists as:
(A) Liquidity coverage targeting
(B) Maturity transformation
(C) Leverage capping
(D) Procyclical provisioning

Oct/Nov 2018

42. Match the terms in List I with their definitions in List II.
List I: (Terms)
P. Financial crisis
Q. Spill-over Effect
R. Macro-prudential
S. Micro-prudential
List II: (Definitions)
1. Focuses on the safety and soundness of individual financial institutions.
2. An event in a country has a ripple effect on the economy of another.
3. Asset prices see a steep decline, businesses cannot pay debts, and institutions experience liquidity shortages.
4. Policies aimed at ensuring the stability of the financial system as a whole.
(A) P-3, Q-2, R-1, S-4
(B) P-3, Q-2, R-4, S-1
(C) P-2, Q-3, R-4, S-1
(D) P-4, Q-1, R-3, S-2

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May/June 2021

43. Consider the following statements regarding systemically important banks (SIBs) and procyclicality:
I Excessive interconnectedness among systemically important banks transmitted shocks across the financial system.
II SIBs are recommended to have loss absorbing capacity strictly capped at the minimum standards.
III To address procyclicality, the Basel Committee introduced a leverage ratio to contain the build-up of excessive leverage.
IV Stressed inputs are recommended for the calculation of value-at-risk and counterparty credit risk.
Which combination of statements is correct?
(A) (I), (II), and (III) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2014

44. Consider the following statements regarding the effect of leverage:
I Borrowing money to purchase an asset magnifies potential profits but insulates the investor against potential losses.
II When house prices declined, the equity of homeowners who had borrowed heavily was quickly wiped out.
III Leverage tends to be procyclical, rising in good times and falling in bad times.
Which combination of statements is correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2007

45. Read the following scenario regarding housing investment and answer the questions that follow:
Pramod is an investor operating during a

Country X have diverged substantially from their long-run trends, leading to speculative bubbles. The central bank of Country X, applying Basel III macro-prudential principles, is highly concerned about the procyclicality of the financial system. It decides to enforce measures that require banks to build up additional capital defenses during this boom period, which can then be drawn down when the economic cycle turns downwards.

Which specific tool recommended by the Basel Committee is designed to achieve the central bank's goal of mitigating procyclicality by requiring capital build-up during a credit boom?

(A) Liquidity coverage ratio
(B) Strict 4.5% minimum common equity requirement
(C) Enhanced Tier 2 capital deductions
(D) Countercyclical buffer

May/June 2024

65. Read the following scenario regarding regulatory review and answer the questions that follow:

Apex Bank operates with heavy reliance on wholesale market funding. During an economic boom, Apex aggressively expanded its balance sheet, increasing its leverage significantly while maintaining its required risk-based capital ratios by investing in assets deemed low risk by rating agencies. The national regulator is conducting a supervisory review and mandates Apex to comply with Basel III's macro-prudential and liquidity measures to ensure it can withstand future systemic shocks.

To address Apex Bank's reliance on short-term wholesale funding and potential disruptions, the regulator will require Apex to maintain sufficient high-quality liquid assets to withstand a specified stressed funding scenario. This requirement is enforced through which standard?

(A) Capital conservation buffer
(B) Liquidity coverage ratio (LCR)
(C) Net stable funding ratio (NSFR)
(D) Countercyclical capital buffer

Oct/Nov 2016

66. Read the following scenario regarding a bank's capital assessment and answer the questions that follow:

Global Bank Corp (GBC) is a large, internationally active bank assessing its capital requirements under the newly implemented Basel III framework. Prior to the crisis, GBC displayed strong Tier 1 capital ratios by taking regulatory deductions from Tier 2 capital, leaving its common equity largely intact. Post-crisis, the regulator informs GBC that it must adhere to stricter definitions of capital to ensure true loss-absorbing capacity. GBC's total risk-weighted assets are calculated at ₹100 billion.

Under the new Basel III guidelines, how must GBC handle its regulatory capital deductions to accurately display its capital ratio?

(A) They must be taken entirely from Tier 2 capital.
(B) They must be proportionally split between Tier 1 and Tier 2 capital.
(C) They are waived entirely if the bank maintains a conservation buffer.
(D) They must be taken from common equity.

May/June 2008

67. Read the following scenario regarding macro-prudential principles and answer the questions that follow:

During an extended period of stable economic growth, housing prices and loan growth in Country X have diverged substantially from their long-run trends, leading to speculative bubbles. The central bank of Country X, applying Basel III macro-prudential principles, is highly concerned about the procyclicality of the financial system. It decides to enforce measures that require banks to build up additional capital defenses during this boom period, which can then be drawn down when the economic cycle turns downwards.

If the central bank of Country X sets the tool identified above to its maximum recommended limit, what percentage of common equity will banks be required to hold for this specific buffer?

(A) 2.0%
(B) 2.5%
(C) 4.5%

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to which bad loans had been extended during the economic boom.

III Fraud was increasingly common, such as overstating a borrower's income.

Which combination of statements is correct?

(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2022

51. Read the following scenario regarding a financial entity and answer the questions that follow:

Zenith Capital is a financial entity that acts as an intermediary channeling savings into investments. It is heavily involved in purchasing long-term mortgage securities. To fund these purchases, Zenith relies entirely on short-term uninsured funds raised from the money markets. It operates outside traditional banking supervision, holds no traditional deposits, and lacks access to the Central Bank's emergency lending facilities. In mid-2007, rumors regarding the declining value of Zenith's mortgage securities spread rapidly.

Based on its operational model and lack of traditional supervision, Zenith Capital is best classified as which of the following?

(A) A regulated commercial bank
(B) A central clearing counterparty
(C) A retail mortgage lender
(D) A shadow bank

Oct/Nov 2015

52. Which of the following pairs correctly matches the liquidity ratio with its objective?

(A) LCR - Addresses longer-term structural liquidity mismatches
(B) NSFR - Withstands a stressed funding scenario over the short-term
(C) NSFR - Serves as a backstop to the risk-based capital requirement
(D) LCR - Requires sufficient high-quality liquid assets for short-term disruptions

May/June 2010

53. Evaluate the following statements regarding capital deductions under Basel III:

I The Committee adopted a stricter definition of common equity, requiring regulatory capital deductions to be taken from common equity.

II This change allows banks to easily display strong Tier 1 capital ratios with limited common equity net of regulatory deductions.

Which of the above statements is/are correct?

(A) Both (I) and (II) are correct
(B) Both (I) and (II) are incorrect
(C) (I) is correct and (II) is incorrect
(D) (I) is incorrect and (II) is correct

Oct/Nov 2022

54. Read the following assertion and reason and select the correct option:

Assertion (A): Under Basel III, it is no longer possible for banks to display strong Tier 1 capital ratios with limited common equity net of regulatory deductions.

Reason (R): The Basel Committee requires regulatory capital deductions to be taken from common equity rather than from Tier 1 or Tier 2 capital.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2013

55. Consider the following statements regarding the Basel III reforms for raising capital levels:

I The minimum requirement for common equity was raised from the 2% level, before regulatory adjustments.

II The new minimum common equity is 4.5% after the application of stricter adjustments.

III Factoring in the capital conservation buffer brings the total common equity requirements to 7%.

IV The new framework eliminated the need for capital requirements against counterparty credit risk.

Which combination of statements is correct?

(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only

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ANSWERS

1. (B) 0% to 2.5%
The Basel Committee introduced a countercyclical buffer to address systemic risk. This buffer consists of common equity ranging from 0% to 2.5% of risk-weighted assets. It aims to protect the banking sector during periods of excess aggregate credit growth. Regulators decide the specific percentage based on the credit-to-GDP ratio and other indicators within their specific national jurisdictions.

2. (C) The NSFR targets short-term structural liquidity mismatches specifically over a 30-day period.
The Net Stable Funding Ratio aims to promote resilience over a longer time horizon by creating incentives for banks to fund their activities with more stable sources. Unlike the Liquidity Coverage Ratio, which focuses on 30-day stress, the NSFR addresses structural liquidity mismatches specifically over a one-year time period. This provides long-term structural incentives for banks to fund activities.

3. (C) Mortgage-backed security
Mortgage-backed securities are financial instruments created by pooling various mortgage loans, including residential and commercial types. These debt instruments allow lenders to sell their loan portfolios to investors, thereby transferring the associated credit risk. This process provides liquidity to the housing market while offering institutional investors exposure to interest and principal payments. This mechanism was central to the global crisis.

4. (C) Serving as a backstop to risk-based requirements and containing excessive leverage build-up.
A non-risk-based leverage ratio was introduced to supplement the risk-based capital framework within Basel III. It serves as a credible backstop that prevents banks from building up excessive leverage. By capping total exposures relative to equity, this measure safeguards the financial system against the risk of institutions attempting to manipulate risk-weighted asset calculations through complex internal modeling techniques.

5. (B) Raising short-term funds in money markets and using them to buy assets with longer-term maturities.
Maturity transformation occurs when financial intermediaries use short-term liabilities to fund long-term assets. This practice involves raising funds in money markets, often through uninsured deposits or wholesale sources, to purchase securities with significantly longer durations. While this generates profit from interest rate spreads, it exposes institutions to significant liquidity risks if short-term funding dries up during market stress.

6. (B) Mitigating procyclicality by retaining earnings in boom times to support operations during stress.
The primary objective of the countercyclical buffer is to reduce the procyclical nature of the financial system. By requiring banks to retain earnings and build capital during economic booms, the framework ensures they have sufficient reserves to absorb losses during downturns. This mechanism helps maintain the steady flow of credit to the economy during stressful periods by avoiding forced deleveraging.

7. (B) Sub-prime loan
Sub-prime loans are credit products extended to borrowers who demonstrate weakened credit histories and higher default risks compared to prime borrowers. These individuals often have limited experience with debt, carry excessive debt relative to their income, or have histories of missed payments. Consequently, these loans carry higher interest rates to compensate for the elevated risk of non-payment or default.

8. (B) To absorb losses during periods of financial and economic stress.
The capital conservation buffer is a mandatory capital layer designed to ensure that banks build up high-quality equity during normal

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CHAPTER 25

Regulatory Capital and Capital Adequacy

May/June 2012

1. Under the Basel III capital regulations as adopted in India, what is the Capital Conservation Buffer (CCB) requirement that banks must maintain in the form of Common Equity Tier 1 capital?
(A) 1.5% of total RWAs
(B) 2.0% of total RWAs
(C) 2.5% of total RWAs
(D) 5.5% of total RWAs

Oct/Nov 2009

2. Identify the INCORRECT statement regarding the treatment of specific provisions on NPAs for risk-weighting purposes.
(A) If specific provisions are less than 20% of the outstanding NPA amount, the risk weight is 150%.
(B) If specific provisions are at least 20% of the outstanding NPA amount, the risk weight is 100%.
(C) If specific provisions reach 50% of the outstanding NPA amount, the risk weight is 0%.
(D) If specific provisions are at least 50% of the outstanding NPA amount, the risk weight is 50%.

May/June 2023

3. What is the fundamental definition of a Primary Dealer?
(A) A non-banking financial company that accepts various demand deposits and issues negotiable cheques.
(B) An international rating agency that assesses the credit risk and financial stability of sovereign nations.
(C) An RBI-registered market maker that buys government securities to resell them to others.
(D) An intermediary that provides loans exclusively for agricultural activities and micro-enterprise development.

Oct/Nov 2018

4. What is the MOST APPROPRIATE definition of "Market Discipline" as envisaged under Pillar 3 of the Basel III capital regulation?
(A) It empowers central banks to penalize non-compliant commercial banks through various monetary sanctions.
(B) It provides a framework for banks to trade their subordinated debt in secondary markets to boost liquidity.
(C) It encourages discipline by requiring banks to disclose details of risks, capital, and management.
(D) It mandates the daily publishing of the internal risk models used for pricing consumer loans to the public.

May/June 2007

5. How does the Internal Rating Based (IRB) approach align with the objective of incentive compatibility?
(A) It assigns standardized risk weights uniformly to all counterparties regardless of their internal ratings.
(B) It encourages banks to continue improving their internal risk management practices.
(C) It requires banks to use ratings provided solely by external credit rating agencies for all transactions.
(D) It limits the amount of equity capital a bank can distribute as dividends to its primary shareholders.

Oct/Nov 2025

6. What is the MOST APPROPRIATE risk weight applied to direct loan or overdraft exposures of banks to State Governments in India?
(A) 0%
(B) 20%
(C) 50%
(D) 100%

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reselling it quickly for a profit. This practice typically occurs during periods of rapid house price appreciation. Investors rely on rising market valuations rather than long-term rental income, contributing to the formation of housing bubbles and increased market volatility within the sector.

17. (A) Daily transaction histories of individual retail depositors
Enhancing market discipline requires financial institutions to provide transparent disclosures regarding their capital base, risk exposures, and liquidity profiles. Information about off-balance sheet commitments and risk concentrations is vital for investors to assess institutional health. However, private details like the daily transaction histories of individual retail depositors are excluded to maintain customer privacy and prevent the disclosure of sensitive data.

18. (A) Paul McCulley
Paul McCulley, an economist at PIMCO, first introduced the term shadow bank during a 2007 speech at a Federal Reserve symposium. He used this phrase to describe the non-bank financial intermediaries that perform maturity transformation without traditional regulatory oversight. These entities provide credit but lack the safety nets, such as deposit insurance or central bank liquidity, available to commercial banks.

19. (D) SIBs are recommended to maintain capital requirements strictly identical to smaller, non-systemic banks.
Systemically important banks are large, interconnected institutions whose failure could disrupt the global financial system. Regulatory bodies recommend that these banks maintain higher loss-absorbing capacity than standard institutions. Unlike smaller, non-systemic banks, they must hold additional capital buffers to mitigate the risks their size and complexity pose to the broader economy and international financial stability during periods of stress.

20. (A) Economic conditions were favorable, with strong growth and expectations that house prices would continue to rise.
Leading up to the Global Financial Crisis, the macroeconomic environment was marked by strong economic growth and low interest rates. Favorable conditions created widespread expectations that house prices would continue to rise indefinitely. This optimism encouraged households to borrow heavily and prompted lenders to lower their standards, facilitating a surge in residential mortgage lending and speculative activity across the global markets.

21. (A) 1, 2, 4, 3
The crisis was preceded by favorable economic conditions that encouraged imprudent borrowing. Banks and investors responded by borrowing heavily to expand lending and purchase mortgage-backed securities. Eventually, house prices declined, which quickly wiped out homeowner equity. This downturn caused default rates within bank credit portfolios to climb, triggering a collapse in the value of securitized mortgage products and broader instability.

22. (C) 4.5%
Basel III significantly increased the requirements for high-quality capital within the banking sector. The new standard sets the minimum common equity requirement at 4.5% after applying stricter regulatory adjustments. This represents a substantial rise from previous levels, ensuring that banks hold more genuine loss-absorbing capital to protect against future financial shocks and enhance overall institutional resilience and systemic safety.

23. (D) The institution cannot rely on market funding during stress, forcing fire-sale of assets.
Institutions heavily reliant on short-term market funding face severe risks during periods of financial stress. If lenders refuse to roll over short-term funds, the institution may experience a liquidity shock. To meet obligations, it might be forced to conduct fire-sales of assets at distressed prices. These losses can quickly deplete capital, turning a liquidity problem into insolvency for the institution.

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needed to support their investment and trading portfolios.

40. (D) Micro-prudential regulation - Dampens procyclicality of financial markets
Micro-prudential regulation is focused on the safety and soundness of individual financial institutions. In contrast, dampening the procyclicality of financial markets is a primary objective of macro-prudential regulation. While micro-prudential rules ensure specific banks are resilient, macro-prudential tools address systemic risks that arise from the collective behavior of institutions and their impact on the broader cyclical economy.

41. (B) Maturity transformation
Maturity transformation is a core function of many financial intermediaries, involving the use of short-term liabilities to fund long-term assets. In the case of Zenith Capital, this meant raising uninsured funds in money markets to purchase mortgage securities with long durations. This practice creates a mismatch that generates profit but leaves the entity highly vulnerable to liquidity shocks and runs.

42. (B) P-3, Q-2, R-4, S-1
A financial crisis involves sharp declines in asset prices and liquidity shortages. Spillovers occur when events in one country impact another's economy through interconnectedness. Macro-prudential policies aim to ensure the stability of the entire financial system. Conversely, micro-prudential regulation focuses on the safety of individual institutions. These different concepts are essential for understanding how regulators manage modern systemic risks.

43. (B) (I), (III), and (IV) only
Systemically important banks often exhibit excessive interconnectedness, which can transmit shocks throughout the global financial system. To manage these risks, Basel III suggests using stressed inputs for calculating risk measures. Additionally, a leverage ratio was introduced to curb the build-up of excessive leverage, addressing the procyclical nature of the financial system and ensuring banks maintain adequate capital cushions.

44. (B) (II) and (III) only
Leverage significantly impacts financial stability because it magnifies both gains and losses. When house prices declined, homeowners who had borrowed heavily saw their equity wiped out almost immediately. Furthermore, leverage is inherently procyclical, as it tends to rise during economic booms when confidence is high and contract sharply during downturns, which can amplify the severity of financial collapses.

45. (C) He loses all of the ₹10,000 equity he initially had.
In the provided scenario, Pramod used ₹10,000 of his own equity and borrowed ₹90,000 to purchase a ₹100,000 property. If the property value drops to ₹90,000, it exactly equals the outstanding loan amount. Consequently, Pramod's initial equity of ₹10,000 is completely exhausted. This demonstrates how high leverage can lead to the total loss of an investor's capital quickly.

46. (B) P-2, Q-3, R-4, S-1
Basel III micro-prudential reforms target several specific areas. The quality of capital is improved through a stricter definition of common equity. Leverage is contained by introducing a non-risk-based backstop ratio. Risk coverage is expanded to include complex, illiquid credit products and derivatives. Finally, liquidity is managed through the introduction of the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

47. (D) Assertion (A) is false, but Reason (R) is true.
Before the Global Financial Crisis, existing prudential regulations failed to stop the accumulation of systemic risk and excessive leverage. These rules were often procyclical, meaning they aggravated economic downturns. As risk measures increased during a crisis, banks were forced to hold more capital, which led to reduced lending and worsened the overall economic situation instead of providing systemic stability.

48. (B) Security possession - Adequate property assets for lenders to sell
Subprime borrowers are characterized by several specific traits that increase lending risk.

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level of at least 7.0% during normal economic periods.

32. (A) (II), (IV), and (V) only
Shadow banks are financial intermediaries that operate outside the traditional banking regulatory perimeter. They perform maturity transformation by using short-term funding to purchase long-term assets, but they lack deposit insurance. Leading up to the crisis, these entities, including securitization vehicles and money market funds, became increasingly dependent on short-term wholesale funding, making them highly susceptible to runs and failures.

33. (A) P-2, Q-4, R-1, S-3
The Basel III framework includes several key components to ensure financial stability. The countercyclical buffer ranges from 0% to 2.5% to mitigate procyclicality. The capital conservation buffer requires an additional 2.5% of common equity. Market discipline involves the disclosure of regulatory capital elements. Finally, systemically important banks are expected to maintain loss-absorbing capacity that exceeds standard minimum requirements for capital.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The introduction of a non-risk-based leverage ratio is a fundamental part of Basel III. It serves as a necessary backstop to risk-based capital requirements, preventing institutions from becoming excessively leveraged through complex asset modeling. This supplementary ratio acts as a safeguard against attempts to "game" risk-weighted measures, ensuring that a minimum level of equity supports total bank exposures.

35. (C) (I) is correct and (II) is incorrect
Shadow banks operate without the safety net of traditional deposit insurance, making them highly susceptible to rumors regarding their solvency. If investors believe an entity is at risk, they may stop providing short-term funding. This forces the shadow bank to sell assets at fire-sale prices, which can quickly lead to insolvency, as few entities can survive such distressed conditions.

36. (A) Extension of the traditional originate-to-distribute business model
The originate-to-distribute business model involves lenders issuing loans with the specific intention of selling them as securitized products to investors. During the lead-up to the crisis, this model was extended to complex and often risky credit products. This practice reduced the lender's incentive to maintain strict underwriting standards, as they did not intend to hold the risk long-term.

37. (A) P-4, Q-1, R-2, S-3
Financial systems face various vulnerabilities. Leverage magnifies both potential profits and losses. Spillovers occur when shocks are transmitted through institutional interconnectedness and cross-border positions. Procyclicality is aggravated when market confidence shifts to caution during bad times. Finally, solvency risk is often triggered when vulnerable institutions face sustained liquidity shocks, forcing them to sell assets at distressed fire-sale prices.

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38. (B) (I), (II), and (III) only
Pre-crisis regulatory shortcomings included the failure of prudential approaches to stop the build-up of systemic risk during economic booms. Existing rules were often procyclical, requiring more capital during downturns as risk measures increased, which worsened economic contractions. Furthermore, market discipline was not effective enough to complement official supervision, and liquidity management often received less attention than institutional solvency risk.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
During the crisis, foreign banks in Europe faced immediate funding problems because they were heavily involved in the U.S. housing market. These institutions had purchased large volumes of mortgage-backed securities, financing these long-term assets with short-term U.S. dollar borrowings. When the MBS market collapsed, these banks could no longer access the funding

24. (D) Eliminating the shadow banking sector entirely
Post-crisis regulatory reforms focused on five critical areas: improving micro-prudential rules, implementing macro-prudential measures, broadening the regulatory perimeter, and enhancing market discipline and coordination. While the reforms aimed to bring shadow banking under better oversight, the goal was not to eliminate the sector entirely, but rather to ensure its systemic risks are properly managed, monitored, and contained effectively.

25. (B) They possess ample property assets that can be used as security by the lender.
Subprime borrowers are individuals characterized by poor credit histories or insufficient income to comfortably manage debt. They often carry excessive debt relative to their earnings and may have a record of late payments. Crucially, these borrowers typically possess very limited property assets to serve as security, making their loans significantly riskier for lenders than traditional prime residential mortgages.

26. (D) Macro-prudential
Macro-prudential policies are designed to maintain the stability of the entire financial system rather than focusing solely on individual institutions. These measures aim to prevent systemic disruptions that could harm credit availability and vital financial services. By addressing risks like procyclicality and interconnectedness, macro-prudential regulation seeks to protect the broader economy from large-scale financial collapses and systemic crises.

27. (A) Foreign banks actively participated in purchasing U.S. mortgage-backed securities using short-term US dollar funding.
The U.S. housing market downturn spread globally because foreign banks were active buyers of American mortgage-backed securities. These international institutions often funded their purchases using short-term U.S. dollar borrowings from wholesale markets. When the value of these securities fell, foreign banks faced massive losses and funding difficulties, demonstrating how interconnectedness transmits financial shocks across national borders and different economic systems.

28. (A) They rely on short-term uninsured funds and lack access to emergency central bank borrowing.
Shadow banks are vulnerable to runs because they rely on short-term, uninsured wholesale funding to finance long-term assets. Unlike commercial banks, they lack access to government-backed deposit insurance and emergency central bank lending facilities. When investors lose confidence and refuse to renew funding, these entities may be forced to sell assets quickly, leading to potential insolvency and systemic collapse.

29. (C) Lenders expected to bear significant long-term losses on their retained loan portfolios.
Lenders aggressively issued risky housing loans because they expected housing prices to continue rising and believed economic conditions would remain favorable. The originate-to-distribute model allowed them to package these loans into securities and sell them to investors, shifting the risk elsewhere. Consequently, lenders did not expect to bear the long-term losses associated with these high-risk portfolios, encouraging imprudent behavior.

30. (D) Deductions are taken from common equity rather than from Tier 1 or Tier 2 capital instruments.
Basel III focuses on raising capital quality by ensuring that common equity is the primary component of loss absorption. To achieve this, the framework requires that regulatory deductions, such as those for goodwill or deferred tax assets, are taken directly from common equity. This change prevents banks from inflating their Tier 1 ratios while holding insufficient high-quality capital net of deductions.

31. (C) Capital conservation buffer - 2.5%
Under the Basel III framework, specific common equity requirements were established to strengthen bank resilience. The capital conservation buffer is set at 2.5% of risk-weighted assets, composed entirely of common equity. This buffer sits above the minimum requirement of 4.5%, meaning that banks should ideally maintain a total common equity

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They often have limited or no experience with debt and a history of late or missed payments. Their income is typically insufficient to cover living expenses plus interest. Most importantly, they lack adequate property assets that lenders could use as security, making recovery difficult in default cases for creditors.

49. (B) (I), (III), (IV), and (V) only
Subprime borrowers represent a high risk of default because they often have poor repayment histories and insufficient income to meet financial obligations. Typically, these individuals have very limited or no property assets to serve as collateral. Unlike prime borrowers, they lack extensive debt experience, making them more vulnerable to economic shifts and increasing the likelihood of significant loan failures during stress.

50. (C) (I) and (III) only
The Global Financial Crisis was driven by several factors, including lax regulation of subprime lending and mortgage-backed securities. Fraud became increasingly common, with some borrowers overstating their income to secure loans. Central banks and regulators did not fully recognize the scale of bad loans extended during the boom, allowing systemic risks to build until the market eventually collapsed in 2007.

51. (D) A shadow bank
Zenith Capital functions as a shadow bank because it operates outside the traditional regulatory framework and performs maturity transformation without access to central bank emergency lending. By relying on short-term uninsured funds to purchase long-term mortgage securities, it mimics bank-like activities without the associated safety nets or supervision, making it highly vulnerable to sudden withdrawals by market investors.

52. (D) LCR - Requires sufficient high-quality liquid assets for short-term disruptions
The Basel III liquidity standards serve distinct purposes. The Liquidity Coverage Ratio ensures that banks maintain a sufficient stock of high-quality liquid assets to survive a short-term, 30-day stressed funding scenario. In contrast, the Net Stable Funding Ratio is designed to address longer-term structural liquidity mismatches across the balance sheet, promoting more sustainable funding models for all financial institutions.

53. (C) (I) is correct and (II) is incorrect
Basel III introduced a stricter definition of common equity to ensure that regulatory capital represents true loss-absorbing capacity. The framework requires that deductions, such as those for goodwill, be taken directly from common equity. This change ensures that banks cannot appear to have strong capital ratios while actually holding very little high-quality equity net of these necessary regulatory adjustments.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Under Basel III, banks can no longer display high Tier 1 capital ratios while holding minimal common equity net of deductions. This is because the Committee now requires that all regulatory capital deductions be taken directly from common equity. This rule ensures that the most loss-absorbing form of capital is used to account for adjustments, providing a more transparent view.

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55. (A) (I), (II), and (III) only
Basel III significantly raised capital requirements by increasing the minimum common equity level to 4.5% after stricter adjustments. When the 2.5% capital conservation buffer is included, the total requirement for common equity reaches 7.0%. These reforms were designed to ensure that banks have a much larger cushion of high-quality capital to absorb losses during periods of extreme financial stress.

56. (A) P-3, Q-4, R-2, S-1
Shadow banking involves several specific attributes. Maturity transformation refers to using short-term funds to buy long-term assets. These entities rely heavily on short-term uninsured wholesale funding and operate without traditional bank regulation or access to central bank emergency lending. Common examples of shadow banking components include securitization vehicles and money

market funds, which performed these roles leading up to crisis.

57. (B) ₹20,000
In the scenario, Pramod purchased a property for ₹100,000 using ₹10,000 of his own equity and a ₹90,000 loan. If the property value increases to ₹110,000, selling it allows him to repay the ₹90,000 principal. This leaves him with ₹20,000 in equity. This example illustrates how leverage can double an investor's initial capital when asset prices rise in favorable conditions.

58. (C) (I) is correct and (II) is incorrect
Prior to the crisis, many banks extended the traditional originate-to-distribute model to encompass highly complex securitized credit products. This shift allowed them to move risks off their balance sheets, but it often led to an over-reliance on rating agencies rather than internal assessments. This model proved vulnerable when the underlying assets lost value and the securitization markets suddenly froze.

59. (A) (I), (II), (III), and (IV) only
Macro-prudential reforms aim to dampen procyclicality by requiring banks to build capital during economic booms. The capital conservation buffer imposes constraints on discretionary distributions, such as dividends, as a bank's capital levels approach the minimum requirement. These measures, along with a countercyclical buffer range of 0% to 2.5%, help ensure that banks remain resilient and continue lending during downturns.

60. (B) (II) and (III) only
While strong capital is essential, it is not sufficient for banking stability without robust liquidity standards. Basel III introduced the Liquidity Coverage Ratio to ensure banks can survive short-term stress using high-quality liquid assets. Additionally, the Net Stable Funding Ratio addresses long-term structural mismatches. Together, these ratios ensure that banks maintain sufficient liquidity and use reliable funding sources.

61. (C) A non-risk-based leverage ratio
To prevent banks like Apex from becoming excessively leveraged, Basel III introduced a non-risk-based leverage ratio. This measure serves as a backstop to risk-based requirements, ensuring that institutions maintain a minimum level of equity relative to their total exposures. It protects the system against instances where risk-weighted asset models might understate the actual risks present on the balance sheet.

62. (B) ₹4.5 billion
Under Basel III, the minimum common equity requirement is set at 4.5% of risk-weighted assets. For Global Bank Corp, with risk-weighted assets totaling ₹100 billion, this percentage translates to a requirement of ₹4.5 billion in high-quality common equity. This minimum must be maintained after applying stricter regulatory adjustments but before considering any additional capital buffers mandated by the new framework.

63. (C) A run on the entity, leading to insolvency if assets must be sold at fire-sale prices.
Zenith Capital relies on short-term wholesale funding, making it vulnerable to a sudden loss of investor confidence. If lenders refuse to renew these funds, the entity faces a run. Without access to central bank support, it may be forced to sell assets at fire-sale prices. This sequence often leads to insolvency, as the distressed sale prices rapidly deplete institutional capital.

64. (B) 2.5%
The Basel Committee recommended a countercyclical buffer consisting of common equity to protect the banking system during periods of excess credit growth. This buffer is designed to be built up during booms and released during stress. The maximum recommended limit for this specific buffer is 2.5% of risk-weighted assets, which sits on top of the minimum capital conservation requirements.

65. (B) Liquidity coverage ratio (LCR)
To ensure Apex Bank can survive short-term liquidity disruptions, regulators require compliance with the Liquidity Coverage Ratio. This standard mandates that banks hold enough high-quality liquid assets to cover their net cash outflows over a 30-day stressed scenario. By maintaining this stock of liquid assets, banks can withstand sudden

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funding withdrawals without being forced into damaging and systemic fire-sales.

66. (D) They must be taken from common equity.
Post-crisis reforms require banks like Global Bank Corp to adhere to stricter definitions of high-quality capital. A key change is that all regulatory capital deductions must now be taken directly from common equity rather than from Tier 1 or Tier 2 instruments. This ensures that the bank's reported capital ratio accurately reflects its most reliable and genuine loss-absorbing equity cushion during stress.

67. (D) Countercyclical buffer
The countercyclical buffer is the specific tool designed to mitigate procyclicality within the financial system. It requires banks to build up additional capital during periods of high credit growth. By accumulating this buffer during booms, banks create a reserve that can be released during economic downturns, helping to maintain the flow of credit when the broader economy faces severe stress.

68. (A) Net stable funding ratio (NSFR)
The Net Stable Funding Ratio is the regulatory standard used to address structural liquidity mismatches over a one-year horizon. It encourages banks to fund their long-term assets with more reliable and stable sources of funding. By implementing this ratio, regulators aim to reduce institutional reliance on volatile short-term wholesale markets, thereby enhancing the long-term stability of the balance sheet.

69. (C) 7.0%
To avoid constraints on discretionary distributions like dividends, a bank must meet both the minimum common equity requirement and the capital conservation buffer. The minimum requirement is 4.5% and the buffer is 2.5%, totaling 7.0% of risk-weighted assets. Maintaining this level ensures the bank has adequate high-quality capital to absorb losses while still being allowed to distribute profits.

70. (B) Existing rules forcing banks to cut back on lending due to depleted capital as risk measures increase.
By requiring banks to build capital buffers during boom times, central banks aim to prevent a situation where institutions must cut back on lending during downturns. Without these buffers, banks might be forced to reduce credit availability as their capital is depleted by rising risks. The countercyclical approach ensures that banks remain capable of supporting the economy even during stressful periods.

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times. This buffer of 2.5% common equity can be drawn down during periods of financial stress to absorb losses. It prevents the depletion of minimum capital requirements and restricts discretionary distributions to preserve institutional solvency and overall financial stability.

9. (B) An excessive reliance on internal bank qualitative assessments rather than rating agencies for asset-backed securities.
During the crisis, risk management failed due to a deterioration in underwriting standards and excessive reliance on rating agencies. Many institutions failed to independently assess complex securitized products, mistakenly trusting external ratings. Additionally, poor management of concentration risks and the extension of the originate-to-distribute model allowed risks to accumulate unnoticed within the global financial system, leading to massive institutional losses.

10. (C) It magnifies both potential profits and potential losses.
Leverage involves using borrowed funds to increase the potential return on an investment. While this strategy can significantly magnify profits when asset prices rise, it equally amplifies potential losses if values decline. High leverage reduces the equity cushion available to absorb shocks, making investors and financial institutions highly vulnerable to even small fluctuations in market prices during volatile economic periods.

11. (A) 4, 2, 1, 3
The financial crisis followed a cascading sequence beginning with a decline in house prices. This led to repossessions where houses were sold below loan balances, causing mortgage-backed security prices to drop. Consequently, the net worth of investors fell, resulting in the failure of major firms like Lehman Brothers. Finally, panicked investors withdrew funds from global banks and investment funds worldwide.

12. (B) Mid 2007 and early 2009
The Global Financial Crisis was a period of severe disruption in international financial markets and banking systems. This era of extreme stress primarily occurred between mid-2007 and early-2009. It was characterized by the collapse of housing bubbles, a sharp contraction in liquidity, and the failure of several major financial institutions, leading to a deep global recession and systemic instability.

13. (A) Current prudential approaches successfully prevented the build-up of systemic risk.
Before the reforms, the macro-prudential framework was insufficient as it failed to prevent the build-up of systemic risk during favorable economic cycles. Existing regulations often aggravated downturns by requiring banks to hold more capital exactly when risk measures increased. This procyclical effect forced banks to cut back on lending, further deepening economic contractions and financial instability rather than preventing them.

14. (C) Broadening the perimeter to ensure all systemic financial activities are adequately captured.
Reforming the regulatory perimeter involves broadening oversight to include all systemic financial activities and entities. This ensures that shadow banking and off-balance sheet transactions are adequately monitored and regulated. By expanding the scope beyond traditional commercial banks, authorities aim to capture risks that were previously hidden and prevent regulatory arbitrage that could destabilize the entire global financial system and economy.

15. (D) Leverage rises in good times when confidence is high and falls in bad times when confidence turns to caution.
Procyclicality refers to the tendency of leverage and credit to fluctuate in tandem with the economic cycle. During economic booms, high confidence encourages institutions to increase leverage and lending. Conversely, when the economy slows, caution leads to a rapid reduction in leverage. This behavior amplifies both economic expansions and contractions, potentially leading to severe financial instability and prolonged economic downturns.

16. (A) House flipping
House flipping is a speculative investment strategy where an individual purchases a revenue-generating property with the intent of

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May/June 2012

7. In the context of a bank's financial statement, how is bank capital fundamentally defined?
(A) The aggregate sum of all tangible property and intangible capital assets held by the institution.
(B) The accounting residual of assets minus liabilities.
(C) The total market value of all short-term investments and liquid cash reserves available.
(D) The specific portion of total assets dedicated to meeting immediate and long-term bank liabilities.

Oct/Nov 2014

8. Identify the correct statement regarding the computation of Potential Future Exposure (PFE) add-ons under the SA-CCR framework.
(A) Offsetting across different hedging sets within a netting set is freely permitted for all derivative classes.
(B) PFE consists of an aggregate add-on and a multiplier recognizing collateral or negative market value.
(C) PFE is calculated strictly by multiplying the nominal amount by a constant 100% conversion factor.
(D) Diversification benefits across asset classes are fully recognized and significantly reduce the aggregated add-on.

May/June 2019

9. Which of the following is NOT an allowable deduction from Common Equity Tier 1 (CET1) capital?
(A) Goodwill and all other intangible assets
(B) Perpetual Non-Cumulative Preference Shares (PNCPS)
(C) Deferred Tax Assets associated with accumulated losses
(D) Defined benefit pension fund assets on the balance sheet

Oct/Nov 2006

10. Which of the following best explains why holding bank capital is considered "expensive" for a bank?
(A) Bank capital is subject to significantly higher taxation rates compared to standard customer deposits.
(B) Holding capital limits a bank's ability to offer consumer loans, thereby reducing its total market share.
(C) Equity holders expect higher returns than liability holders due to the greater risk taken.
(D) Managing capital requires the bank to hire expensive external credit assessment institutions for compliance.

May/June 2021

11. The following are basic steps to arrive at risk-weighted exposures under the standardized approach for credit risk:
I. Determine the applicable risk-weight based on exposure class or rating grade.
II. Calculate any on-balance sheet exposure amount for a borrower.
III. Allocate each borrower or counterparty to the relevant exposure class.
IV. Calculate the credit-equivalent amount for off-balance sheet exposures.
V. Calculate total risk-weighted exposure by multiplying risk-weight with the adjusted exposure.
What is the correct sequential order of these steps?
(A) I, III, II, IV, V
(B) III, I, II, IV, V
(C) III, II, I, IV, V
(D) II, III, I, V, IV

Oct/Nov 2010

12. According to the prescribed RBI guidelines for scheduled commercial banks operating in India, what is the minimum Total Capital to Risk Weighted Assets Ratio (CRAR) that must be maintained on an ongoing basis?
(A) 5.5%
(B) 7.0%
(C) 9.0%
(D) 11.5%

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May/June 2005

13. Identify the INCORRECT statement concerning the regulatory retail portfolio qualifying criteria.
(A) Consumer credit and credit card receivables are always included in the regulatory retail portfolio.
(B) The exposure must be to an individual person or persons or to a specific small business entity.

May/June 2019

61. Omni Bank has a performance bond with a Credit Equivalent Amount (CEA) of INR 5 crore and a trade LC with a CEA of INR 1.0 crore. If these unrated corporate claims attract a risk weight of 100%, what is the combined RWA for both instruments?
(A) INR 3.0 crore
(B) INR 6.0 crore
(C) INR 7.5 crore
(D) INR 15.0 crore

Oct/Nov 2006

62. Zenith Bank has an NPA account with an outstanding balance of INR 20.0 crore and has made a specific provision of INR 3.0 crore. What is the level of specific provisions expressed as a percentage of the outstanding NPA amount for determining the risk weight?
(A) 10%
(B) 15%
(C) 16.67%
(D) 20%

May/June 2021

63. Delta Bank has a Cash Credit facility with an outstanding amount of INR 5.5 crore and a Credit Equivalent Amount (CEA) for the undrawn portion of INR 0.1 crore. What is the total Risk-Weighted Asset (RWA) amount for this exposure, assuming it is categorized in the regulatory retail portfolio and attracts a 75% risk weight?
(A) INR 4.125 crore
(B) INR 4.200 crore
(C) INR 4.500 crore
(D) INR 5.600 crore

Oct/Nov 2010

64. Apex Bank extends a term loan of INR 50 crore, fully collateralized by State Government debt securities valued at INR 60 crore. If the haircut for the collateral is 2% and the haircut for the exposure is 0%, what is the volatility-adjusted value of the collateral?
(A) INR 55.2 crore
(B) INR 57.6 crore
(C) INR 58.8 crore
(D) INR 60.0 crore

May/June 2016

65. Omni Bank issues a performance bond of INR 10 crore on behalf of an unrated corporate client. What is the Credit Equivalent Amount (CEA) for the performance bond?
(A) INR 2 crore
(B) INR 5 crore
(C) INR 7.5 crore
(D) INR 10 crore

Oct/Nov 2022

66. Zenith Bank has an NPA account with an outstanding balance of INR 20.0 crore. The bank has made a specific provision of INR 3.0 crore against this account. The exposure is secured by a pledged term deposit of INR 2.0 crore, which is recognized as eligible collateral for risk mitigation. What is the unsecured portion of the NPA, net of specific provisions and eligible collateral?
(A) INR 15.0 crore
(B) INR 17.0 crore
(C) INR 18.0 crore
(D) INR 20.0 crore

May/June 2014

67. Apex Bank extends a term loan of INR 50 crore to a corporate entity rated 'A'. The facility is fully collateralized by debt securities issued by the State Government (residual maturity 3 years) valued at INR 60 crore. There is no currency mismatch. What is the standard supervisory haircut for the State Government debt securities?
(A) 0.5%
(B) 2%
(C) 4%
(D) 8%

Oct/Nov 2005

68. Omni Bank extends an irrevocable short-term self-liquidating trade Letter of Credit (LC) for INR 5 crore. Using a Credit Conversion Factor (CCF) of 20%, what is the Credit Equivalent Amount (CEA) for this short-term self-liquidating trade LC?
(A) INR 0.5 crore
(B) INR 1.0 crore
(C) INR 2.5 crore
(D) INR 5.0 crore

May/June 2025

69. Zenith Bank has an NPA account with an outstanding balance of INR 20.0 crore and specific provisions representing 15% of the

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currency exposure (UFCE) where the Likely Loss / EBID is more than 75%?
(A) It requires a 25% increase in the risk weight.
(B) It attracts a 0% incremental capital requirement.
(C) It attracts a 125% uniform risk weight.
(D) It leads to a full deduction from Tier 1 capital.

May/June 2009

21. The following are steps for calculating the Potential Future Exposure (PFE) Add-ons of a netting set:
I. Aggregate add-ons across all hedging sets and asset classes within the netting set.
II. Allocate derivative trades to asset classes.
III. Calculate hedging set level PFE add-ons using effective notionals and supervisory factors.
IV. Allocate those derivative trades to hedging sets within each asset class.
V. Calculate the effective notional based on parameters of that trade for every derivative trade.
What is the correct chronological order of these steps?
(A) II, IV, V, III, I
(B) II, V, IV, III, I
(C) IV, II, V, I, III
(D) V, II, IV, III, I

Oct/Nov 2011

22. Under the Basel III capital regulations as adopted in India, what is the minimum Common Equity Tier 1 (CET1) capital ratio requirement that banks must maintain on an ongoing basis?
(A) 1.5%
(B) 2.5%
(C) 5.5%
(D) 7.0%

May/June 2010

23. In the context of the comprehensive approach to credit risk mitigation, what is the conceptual effect of applying "haircuts" to exposures and collaterals?
(A) The haircut produces a discounted amount for the exposure and a premium factor for the collateral.
(B) Haircuts equalize the value of the exposure and the collateral regardless of market movements.
(C) Haircuts completely eliminate the currency mismatch risk without affecting the base value of the collateral.
(D) Volatility adjustments increase the exposure amount while decreasing the collateral value.

Oct/Nov 2024

24. All of the following are recognized asset classes under the Internal Rating Based (IRB) approach, EXCEPT:
(A) Corporate
(B) Sovereign
(C) Retail
(D) Off-Balance Sheet Unhedged Currency

May/June 2017

25. Identify the INCORRECT statement regarding the elements of Additional Tier 1 Capital.
(A) It provides a permanent and unrestricted commitment of funds for the institution.
(B) It must be at least 7% of RWAs before accounting for Common Equity Tier 1.
(C) It includes Perpetual Non-Cumulative Preference Shares (PNCPS) complying with regulatory requirements.
(D) It includes stock surplus resulting from the issue of instruments included in Additional Tier 1 capital.

Oct/Nov 2005

26. Under the Internal Rating Based (IRB) approach, what does the term Exposure at Default (EAD) represent?
(A) The percentage of the loan that the bank might lose in case the borrower defaults on their obligations.
(B) The mathematical probability that a borrower will default on their debt within a standard one-year horizon.
(C) The conditional expected loss for an exposure calculated using an asymptotic single risk factor model.
(D) The estimated amount outstanding at the time a borrower defaults.

May/June 2020

27. Which is the BEST reason provided for why safety nets like deposit insurance might cause banks to hold less equity capital?

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(C) Total average annual turnover for small businesses must be less than a threshold of INR 50 crore.
(D) Aggregate exposure to a single counterparty should not exceed 0.2% of the overall regulatory retail portfolio.

Oct/Nov 2022

14. Identify the correct statement regarding the treatment of Revaluation Reserves as Common Equity Tier 1 (CET1) capital.
(A) Revaluation reserves are entirely excluded from CET1 and are only considered as Tier 2 capital.
(B) Revaluation reserves are considered CET1 capital without any discount if the bank intends to sell the property.
(C) Realistic revaluation reserves are reckoned as CET1 capital at a 55% discount.
(D) Revaluation reserves can be reckoned as CET1 capital at a discount of 25% provided the property is appraised annually.

May/June 2018

15. In the context of SA-CCR, what is the MOST APPROPRIATE description of a "netting set"?
(A) A portfolio of only exchange-traded derivatives without any margin requirements or clearing house oversight.
(B) A collection of cash flow hedges adjusted against general provisions to mitigate interest rate volatility.
(C) A specific account used to capture all unhedged foreign currency exposures of a bank across different branches.
(D) A group of transactions with a counterparty subject to a legally enforceable bilateral netting arrangement.

Oct/Nov 2016

16. What is the fundamental definition of Common Equity Tier 1 (CET1) capital from a regulatory perspective?
(A) Highest quality capital available to absorb losses on a going-concern basis.
(B) Capital that is primarily intended to absorb losses only in a situation involving the full liquidation of the bank.
(C) Instruments consisting entirely of perpetual non-cumulative preference shares and various subordinated debt securities.
(D) An accounting residual restricted from absorbing losses on a going-concern basis while the bank remains operational.

May/June 2014

17. In the context of risk weight applicable to non-market related off-balance sheet items, which of the following instruments does NOT attract a 100% Credit Conversion Factor (CCF)?
(A) Short-term self-liquidating trade letters of credit from movement of goods.
(B) Direct credit substitutes like standby L/Cs serving as financial guarantees for borrowers.
(C) Forward asset purchases and forward deposits committed to by the bank for future dates.
(D) Sale and repurchase agreements with recourse that involve the transfer of high-quality assets.

Oct/Nov 2007

18. For an unrated claim on a corporate where the aggregate exposure from the banking system is more than INR 200 crore, what is the applicable risk weight?
(A) 50%
(B) 100%
(C) 125%
(D) 150%

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May/June 2025

19. Identify the INCORRECT statement regarding Eligible Financial Collateral under the comprehensive approach.
(A) Cash on deposit with the bank incurring the counterparty exposure is an eligible form of collateral.
(B) Kisan Vikas Patra is eligible provided no lock-in period is operational and they can be encashed easily.
(C) Gold jewelry is eligible, but its value must be arrived at after notionally converting it to 99.99 purity.
(D) Re-securitisations with a AAA credit rating are considered eligible financial collateral.

Oct/Nov 2019

20. Which statement correctly describes the risk weight applicable to an unhedged foreign

R. Three years and more but less than four years
S. Four years and more but less than five years

List II: (Applicable Rate of Discount)
1. 80%
2. 40%
3. 100%
4. 20%

(A) P-3, Q-1, R-2, S-4
(B) P-1, Q-3, R-4, S-2
(C) P-3, Q-4, R-1, S-2
(D) P-4, Q-1, R-2, S-3

Oct/Nov 2017

34. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R). Read the statements and select the correct option:

Assertion (A): An unrated short-term claim on a counterparty can attract a risk weight lower than 30% if the rated short-term facility attracts a 20% risk weight.

Reason (R): The unrated short-term claim on a counterparty will attract a risk weight of at least one level higher than the risk weight applicable to the rated short-term claim on that counterparty.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2008

35. Read the following statements regarding Maturity Mismatch in Credit Risk Mitigation (CRM):

I A maturity mismatch occurs when the residual maturity of collateral is less than that of the underlying exposure.
II Collateral with maturity mismatches is recognised even if its original maturity is less than one year.

Which of the above statements is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2013

36. Global Trust Bank has a fund-based exposure to an AA rated corporate entity (long term rating), fully uncovered by ECGC, amounting to INR 500 crore. What is the risk-weighted asset (RWA) value for this corporate exposure?
(A) INR 100 crore
(B) INR 150 crore
(C) INR 250 crore
(D) INR 500 crore

May/June 2015

37. Match the items in List I with the corresponding items in List II based on the standardized approach for credit risk:

List I: (Asset Class / Exposure)
P. Central Government guaranteed claims
Q. Claims on ECGC
R. Regulatory Retail Portfolio
S. Venture Capital Funds

List II: (Risk Weight)
1. 20%
2. 75%
3. 0%
4. 150%

(A) P-3, Q-1, R-2, S-4
(B) P-1, Q-4, R-3, S-2
(C) P-3, Q-2, R-1, S-4
(D) P-4, Q-1, R-2, S-3

Oct/Nov 2012

38. Read the following criteria for claims to be included in the regulatory retail credit portfolio:

I The exposure is to an individual person or persons or to a small business.
II Total Average Annual Turnover of the small business over the last 3 years is less than INR 50 crore.
III The exposure takes the form of revolving credits, lines of credit, term loans, or leases.
IV The maximum aggregated retail exposure to one counterpart exceeds the absolute threshold limit of INR 7.5 crore.

Which of the above statements outline the CORRECT criteria?
(A) (I), (II) and (III) only

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(A) Safety nets reduce depositor monitoring, which indirectly subsidizes bank risk-taking.
(B) Deposit insurance premiums directly deplete the Common Equity Tier 1 capital base of the bank.
(C) Bailouts legally prevent banks from issuing new equity shares to the public during a financial crisis.
(D) Regulatory authorities enforce a maximum capital cap when a safety net is active within the banking system.

Oct/Nov 2015

28. What is the conceptual distinction between "going-concern capital" and "gone-concern capital"?
(A) Going-concern capital absorbs losses during operations, while gone-concern capital does so at liquidation.
(B) Going-concern capital protects the bank's fixed assets, whereas gone-concern capital protects liquid assets.
(C) Going-concern capital is composed of subordinated debt, whereas gone-concern capital comprises Common Equity Tier 1.
(D) Going-concern capital is maintained under Pillar 2, whereas gone-concern capital is mandated by Pillar 3.

May/June 2013

29. All of the following claims are excluded from the regulatory retail portfolio (for which separate risk weights are prescribed), EXCEPT:
(A) Exposures by way of investments in listed equities held for trading or long-term investment.
(B) Mortgage loans qualifying as claims secured by residential property under specific LTV guidelines.
(C) Term loans to small businesses meeting turnover and granularity criteria.
(D) Venture Capital Funds that are invested in early-stage startups or growth-oriented private companies.

Oct/Nov 2021

30. Identify the correct statement about the treatment of Deferred Tax Assets (DTAs) in calculating Common Equity Tier 1 capital.
(A) DTAs associated with accumulated losses are added to Common Equity Tier 1 capital during calculation.
(B) DTAs can be fully offset against General Provisions without impacting the bank's CET1 capital ratio.
(C) DTAs are ignored entirely while calculating the regulatory capital of a bank under standardized approaches.
(D) DTAs associated with accumulated losses are deducted from Common Equity Tier 1 capital.

May/June 2024

31. Which of the following of Derivative Transaction and its Primary Risk Driver is CORRECTLY matched under the SA-CCR?
(A) FX call option : Interest rate curve of the base currency.
(B) Interest Rate Swap : FX rate volatility between two major currencies.
(C) Credit Default Swap : Credit of reference entity.
(D) Forward asset purchase : Equity price of the underlying market index.

Oct/Nov 2008

32. Read the following items used for computing bank capital:
I Stock surplus (share premium) resulting from the issue of common shares.
II Statutory reserves.
III Goodwill and all other intangible assets.
IV Revaluation reserves (at a discount of 55%).
V Deferred Tax Assets associated with accumulated losses.
Which combination of the above items must be INCLUDED as positive elements in calculating Common Equity Tier 1 (CET1) capital prior to regulatory adjustments?
(A) (I), (II) and (IV) only
(B) (I), (II), (III) and (V) only
(C) (I), (III) and (IV) only
(D) (II), (IV) and (V) only

May/June 2006

33. Match the items in List I with the corresponding items in List II based on the regulatory capital requirements for banks:
List I: (Remaining Maturity of Tier 2 Debt Capital Instruments)
P. Less than 1 year
Q. One year and more but less than two years

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II Advanced IRB (AIRB) requires the bank to estimate Probability of Default (PD), EAD, and LGD.
III In India, the regulatory decision was made in 2007 that all commercial banks must immediately adopt the Advanced IRB approach for credit risk.

Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II) and (III)

May/June 2005

45. Global Trust Bank has a State Government guaranteed claim of INR 1500 crore classified as a standard asset. What is the risk-weighted asset (RWA) value for this exposure?
(A) INR 0 crore
(B) INR 300 crore
(C) INR 750 crore
(D) INR 1500 crore

Oct/Nov 2023

46. Match the items in List I with the corresponding items in List II based on the standardized approach for credit risk:
List I: (Domestic Rating Agency Long Term Rating)
P. AAA
Q. AA
R. A
S. BBB
List II: (Standardized Risk Weight)
1. 50%
2. 100%
3. 30%
4. 20%
(A) P-4, Q-3, R-1, S-2
(B) P-3, Q-4, R-2, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-1, Q-2, R-4, S-3

May/June 2018

47. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R). Read the statements and select the correct option:
Assertion (A): Banks are generally permitted to freely use unsolicited ratings from credit rating agencies to calculate risk-weighted assets under the Standardised Approach.
Reason (R): A rating is treated as solicited only if the issuer of the instrument has requested the rating and accepted it.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2009

48. Which of the following pairs of Non-market related Off-Balance Sheet Instrument and its Credit Conversion Factor (CCF) is INCORRECTLY matched?
(A) Commitments with certain drawdown : 100% CCF.
(B) Certain transaction-related contingent items : 20% CCF.
(C) Unconditional take-out finance : 100% CCF.
(D) Note issuance facilities and revolving underwriting facilities : 50% CCF.

May/June 2022

49. Read the following statements regarding standard supervisory haircuts for credit risk mitigation:
I Haircut for cash in the same currency is 0%.
II Haircut for gold is 15%.
III Haircut for Securitization Exposure (AAA to AA, 5 years) is 16%.
IV Currency mismatch haircut is 8%.
V Haircut for Sovereign securities (AAA to AA, $\leq$ 1 year) is 0.5%.

Which of the above statement(s) is/are correct?
(A) (I), (II) and (IV) only
(B) (II), (III), (IV) and (V) only
(C) (I), (III) and (V) only
(D) (I), (II), (III), (IV) and (V)

Oct/Nov 2014

50. Read the following statements about NPAs secured by collaterals:
I Land and building valued by an expert

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valuer, not more than three years old, qualify for a 100% risk weight when specific provisions reach 15% of the outstanding amount.

II Plant and machinery in good working condition are eligible if they are not older than eighteen months.

III These forms of collaterals are widely recognized under the standardized approach for performing assets as well.

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II) and (III)

May/June 2010

51. Delta Bank has extended a Cash Credit limit to an MSME unit with an average annual sales turnover of INR 45 crore over the last 3 years. The Cash Credit limit is INR 6.0 crore, and the outstanding amount is INR 5.5 crore. Delta Bank has an overall Regulatory Retail Portfolio of INR 4000 crore. Does this exposure qualify for inclusion in the Regulatory Retail Credit Portfolio under the turnover and granularity criteria?

(A) No, because the turnover exceeds INR 50 crore for this specific counterparty.
(B) No, because the total exposure to the single counterparty exceeds 0.2% of the overall regulatory retail portfolio.
(C) Yes, but only the drawn portion (INR 5.5 crore) is evaluated against the granularity limit.
(D) Yes, turnover is under INR 50 crore and exposure is $\leq$ 0.2% of retail portfolio.

Oct/Nov 2020

52. Which of the following pairs of Exposure Type and its Risk Weight is CORRECTLY matched?

(A) Advances classified as 'Capital market exposures' : 75% risk weight.
(B) Non-Banking Financial Companies (NBFC-ND-SI) : 150% risk weight uniformly.
(C) Claims on MDBs, BIS and IMF : 50% risk weight.
(D) Consumer credit (excluding credit cards and education) : 100% or higher.

May/June 2015

53. Read the following statements regarding the unsecured portion of NPAs (other than qualifying residential mortgage loans):

I A 150% risk weight applies when specific provisions are less than 20% of the outstanding amount of the NPA.

II A 50% risk weight applies when specific provisions are at least 50% of the outstanding amount of the NPA.

Which of the above statements is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

Oct/Nov 2007

54. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R). Read the statements and select the correct option:

Assertion (A): Tier 2 capital provides a lower level of protection for depositors and other creditors compared to Tier 1 capital.

Reason (R): Tier 2 capital absorbs losses without the bank being required to cease operations.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2024

55. Read the following statements regarding the treatment of off-balance sheet items in bank capital calculations:

I The notional amount of the transaction is converted into a credit equivalent amount using a Credit Conversion Factor (CCF).

II Direct credit substitutes attract a CCF of 50%.

III Short-term self-liquidating trade letters of credit attract a CCF of 20%.

IV Similar commitments that are

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unconditionally cancellable at any time by the bank without prior notice attract a CCF of 0%.

Which of the above statement(s) is/are correct?

(A) (I), (II) and (IV) only
(B) (I), (III) and (IV) only
(C) (II), (III) and (IV) only
(D) (I), (II), (III) and (IV)

Oct/Nov 2011

56. Match the items in List I with the corresponding items in List II based on the comprehensive approach for credit risk mitigation:

List I: (Eligible Financial Collateral Type)

P. Cash in the same currency
Q. Gold
R. Securitization Exposure (AAA to AA, ≤ 1 year)
S. Currency mismatch haircut

List II: (Standard Supervisory Haircut)

1. 8%
2. 2%
3. 0%
4. 15%

(A) P-3, Q-4, R-2, S-1
(B) P-2, Q-3, R-1, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-1, Q-4, R-2, S-3

May/June 2008

57. Global Trust Bank has a Central Government guaranteed claim of INR 4000 crore classified as a standard asset. What is the risk-weighted asset (RWA) value for this exposure?

(A) INR 0 crore
(B) INR 800 crore
(C) INR 2000 crore
(D) INR 4000 crore

Oct/Nov 2025

58. Read the following statements regarding the Internal Rating Based (IRB) approach:

I The PD associated with a given borrower depends heavily on the features of the specific transaction such as collateral.
II LGD is facility-specific because losses are influenced by key transaction characteristics like the presence of collateral.

Which of the above statements is/are correct?

(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2013

59. Read the following rules regarding the scope of application of external ratings for risk-weighting:

I Banks must use the chosen credit rating agencies consistently for each type of claim.
II Banks are allowed to "cherry pick" assessments to minimize risk-weighted assets.
III The rating must reflect the entire amount of credit risk exposure, including both principal and interest.
IV If a bank uses two ratings that map into different risk weights, the lower risk weight should be applied.
V If there are three or more ratings, the ratings corresponding to the two lowest risk weights are referred to, and the higher of those two is applied.

Which of the above statement(s) is/are INCORRECT?

(A) (II) and (IV) only
(B) (I), (III) and (V) only
(C) (II), (IV) and (V) only
(D) (I) and (III) only

Oct/Nov 2016

60. Read the following statements about the Credit Risk Mitigation (CRM) Comprehensive Approach:

I It allows partial or fuller offset of collateral against exposures by reducing the exposure amount by the value ascribed to the collateral.
II Haircuts are applied to both the exposure and the collateral to account for future market fluctuations.
III The haircut for the exposure serves as a discount factor, decreasing the volatility adjusted exposure amount.

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II) and (III)

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(B) (II), (III) and (IV) only
(C) (I), (III) and (IV) only
(D) (I), (II), (III) and (IV)

May/June 2011

39. Given below are two statements: one is labelled as Assertion (A) and the other is labelled as Reason (R). Read the statements and select the correct option:
Assertion (A): Having more capital in the bank gives shareholders an incentive to encourage bank management to act more prudently.
Reason (R): As capital deteriorates, shareholders' potential losses shrink to their initial investment, but possible gains remain unlimited, incentivizing excessive risk-taking when capital is low.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2020

40. Which of the following pairs of LTV ratio and Risk Weight for claims secured by residential property is INCORRECTLY matched?
(A) Outstanding loan up to INR 30 lakh, LTV $\leq$ 80% : Risk Weight 35%
(B) Outstanding loan up to INR 30 lakh, LTV 80% and $\leq$ 90% : Risk Weight 50%
(C) Outstanding loan above INR 75 lakh, LTV $\leq$ 75% : Risk Weight 50%
(D) Loan INR 30–75 lakh, LTV $>$ 80% : Risk Weight 35%

May/June 2022

41. Delta Bank has extended a Cash Credit limit of INR 6.0 crore to an MSME unit, and the current outstanding amount is INR 5.5 crore. What is the Credit Equivalent Amount (CEA) for the undrawn commitment of the Cash Credit facility, assuming a 20% Credit Conversion Factor (CCF) for undrawn lines?
(A) INR 0.1 crore
(B) INR 0.5 crore
(C) INR 1.1 crore
(D) INR 1.2 crore

Oct/Nov 2023

42. Match the items in List I with the corresponding definitions in List II based on the Internal Rating Based (IRB) approach:
List I: (IRB Approach Terminology)
P. Probability of Default (PD)
Q. Loss Given Default (LGD)
R. Exposure at Default (EAD)
S. Effective Maturity (M)
List II: (Definition)
1. Estimate of amount outstanding when borrower defaults
2. Likelihood that borrower will default within one year horizon
3. Remaining time to fully discharge contractual obligation
4. Percentage of exposure the bank might lose if default occurs
(A) P-2, Q-4, R-1, S-3
(B) P-4, Q-2, R-3, S-1
(C) P-2, Q-1, R-4, S-3
(D) P-1, Q-3, R-2, S-4

May/June 2016

43. Read the following statements about the Standardized Approach for Counterparty Credit Risk (SA-CCR):
I It calculates the exposure amount of derivative contracts at the netting set level.
II EAD is computed as $1.4 \times (RC + PFE)$.
III RC stands for Replacement Cost and PFE stands for Potential Future Exposure.
IV The multiplier in the PFE calculation can reach absolute zero if excess collateral is high enough.
Which of the above statement(s) is/are correct?
(A) (I), (II) and (III) only
(B) (II), (III) and (IV) only
(C) (I), (II) and (IV) only
(D) (I), (II), (III) and (IV)

Oct/Nov 2012

44. Read the following statements regarding the Internal Rating Based (IRB) approach:
I Under Foundation IRB (FIRB), the supervisor supplies inputs such as Loss Given Default (LGD) and Exposure at Default (EAD).

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outstanding amount. For the net unsecured portion of INR 15.0 crore, what is the applicable risk weight?
(A) 50%
(B) 75%
(C) 100%
(D) 150%

Oct/Nov 2019

70. Apex Bank has a loan exposure of INR 50 crore and a volatility-adjusted collateral value of INR 58.8 crore. What is the exposure amount after risk mitigation (E*), and the resulting RWA for this transaction?
(A) E* = INR 0 crore, RWA = INR 0 crore
(B) E* = INR 8.8 crore, RWA = INR 4.4 crore
(C) E* = INR 50 crore, RWA = INR 25 crore
(D) E* = INR 58.8 crore, RWA = INR 29.4 crore

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70. (A) E* = INR 0 crore, RWA = INR 0 crore
When the volatility-adjusted value of the collateral exceeds the volatility-adjusted value of the exposure, the net exposure after risk mitigation is zero. In this case, the adjusted collateral of fifty-eight point eight crore rupees more than covers the fifty crore rupee loan. Therefore, the exposure amount after mitigation is zero, resulting in zero risk-weighted assets for the bank.

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over time, with a multiplier. This multiplier adjusts the exposure based on factors such as collateral and negative market value, reflecting the actual risk profile of the transactions.

9. (B) Perpetual Non-Cumulative Preference Shares (PNCPS)
Regulatory capital calculations require specific deductions from common equity tier one capital to ensure its high quality. While goodwill, intangible assets, and deferred tax assets from losses must be deducted, perpetual non-cumulative preference shares are not subtracted. Instead, these instruments are typically classified as additional tier one capital, provided they meet the specific regulatory criteria for inclusion in that category.

10. (C) Equity holders expect higher returns than liability holders due to the greater risk taken.
Holding capital is perceived as costly for banks because equity represents the most expensive form of funding. Shareholders demand a higher rate of return compared to depositors or debt holders because they bear the highest risk of loss. Consequently, increasing capital requirements can raise the overall cost of funds for the bank, impacting its profitability and lending rates.

11. (B) III, I, II, IV, V
To calculate risk-weighted exposures under the standardized approach, banks must follow a specific sequence. First, borrowers are allocated to relevant exposure classes. Next, applicable risk weights are determined based on these classes or credit ratings. Finally, the bank calculates on-balance sheet and off-balance sheet amounts, multiplying the adjusted exposures by the designated risk weights to reach the total.

12. (C) 9.0%
The Reserve Bank of India mandates that scheduled commercial banks maintain a minimum total capital to risk-weighted assets ratio. While international Basel standards suggest a lower baseline, Indian regulations require a more conservative nine percent ratio on an ongoing basis. This requirement ensures that banks operating within the country have sufficient capital buffers to absorb potential losses and maintain systemic stability.

13. (A) Consumer credit and credit card receivables are always included in the regulatory retail portfolio.
The regulatory retail portfolio has specific criteria, including turnover limits for small businesses and granularity requirements to ensure diversification. While many retail loans qualify, it is incorrect to state that consumer credit and credit card receivables are always included. These items often have distinct risk weights or treatment under different regulatory segments, making the universal inclusion claim factually inaccurate.

14. (C) Realistic revaluation reserves are reckoned as CET1 capital at a 55% discount.
Banks are permitted to include realistic revaluation reserves in their common equity tier one capital calculations. However, to account for the potential volatility in property values and the lack of immediate liquidity, these reserves must be included at a significant discount. Specifically, the regulatory guidelines require a fifty-five percent discount, meaning only forty-five percent of the reserve value is recognized.

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15. (D) A group of transactions with a counterparty subject to a legally enforceable bilateral netting arrangement.
In the context of counterparty credit risk, a netting set refers to a group of transactions with a single counterparty that are covered by a legally enforceable bilateral netting agreement. This arrangement allows the bank to offset positive and negative market values across different contracts. Consequently, the regulatory exposure is calculated on a net basis rather than an individual transaction basis.

16. (A) Highest quality capital available to absorb losses on a going-concern basis.
Common equity tier one capital represents the highest quality of regulatory capital available to a bank. It consists primarily of common shares and retained earnings, which provide the most effective means of absorbing losses on a going-concern basis. This capital ensures that the bank can continue its operations even when

bank, the exposure qualifies for the retail category.

52. (D) Consumer credit (excluding credit cards and education) : 100% or higher.
Risk weights vary significantly across different exposure types. Capital market exposures and many NBFC exposures attract higher weights, often one hundred and twenty-five percent or more. While claims on certain multilateral institutions carry zero percent, consumer credit items like personal loans typically attract a hundred percent risk weight, reflecting their higher inherent credit risk compared to other more secured lending.

53. (C) Both (I) and (II) are correct
The risk weight for the unsecured portion of a non-performing asset is determined by the level of specific provisions. If provisions are below twenty percent of the outstanding amount, a one hundred and fifty percent risk weight is applied. Conversely, if specific provisions are at least fifty percent of the outstanding amount, the applicable risk weight is reduced to fifty percent.

54. (C) Assertion (A) is true, but Reason (R) is false.
Tier two capital is considered gone-concern capital, meaning it is intended to absorb losses only after a bank has failed and entered liquidation. It provides less protection to creditors than tier one capital, which absorbs losses during normal operations. Therefore, the reason is false because tier two capital generally does not absorb losses while the bank remains a going concern.

55. (B) (I), (III) and (IV) only
Calculating capital for off-balance sheet items involves using credit conversion factors. Short-term trade letters of credit attract a twenty percent factor, while unconditionally cancellable commitments attract zero percent. However, direct credit substitutes such as financial guarantees represent a high credit risk and attract a hundred percent conversion factor, not fifty percent as stated in one of the provided statements.

56. (A) P-3, Q-4, R-2, S-1
Under the comprehensive approach, standard supervisory haircuts are assigned to different collateral types. Cash in the same currency requires no haircut. Gold is assigned a fifteen percent haircut to account for price volatility. Short-term highly rated securitization exposures have a two percent haircut, while a currency mismatch between the exposure and collateral necessitates an eight percent haircut for risk mitigation.

57. (A) INR 0 crore
Exposures that are guaranteed by the central government are treated as having no credit risk under the standardized approach. Consequently, these claims attract a zero percent risk weight. This means that regardless of the exposure amount, the resulting risk-weighted asset value for the bank is zero crore rupees, reflecting the highest level of credit safety provided by the sovereign guarantee.

58. (B) Only (II) is correct
In the internal ratings-based approach, probability of default is generally considered a borrower-specific parameter that does not depend on the features of a specific transaction or collateral. In contrast, loss given default is facility-specific because the potential loss is directly influenced by transaction characteristics like the presence and quality of collateral. Therefore, only the statement regarding loss given default is correct.

59. (A) (II) and (IV) only
Regulatory rules for using external ratings prevent banks from selectively choosing assessments to lower their capital requirements. If two ratings result in different risk weights, the bank must apply the higher risk weight, not the lower one. These rules ensure consistency and prevent "cherry picking," which would undermine the accuracy and conservative nature of the risk-weighted asset calculation.

60. (A) (I) and (II) only
The comprehensive approach for credit risk mitigation involves adjusting both the exposure and the collateral for potential price volatility. While haircuts are applied to both, the haircut for the exposure acts as a premium that increases

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percent of risk-weighted assets is incorrect. The minimum regulatory requirement for additional tier one capital is generally much lower, around one point five percent.

26. (D) The estimated amount outstanding at the time a borrower defaults.
In the internal ratings-based framework, exposure at default represents one of the key risk parameters used to calculate capital requirements. It is an estimate of the total amount that will be outstanding on a credit facility at the moment the borrower defaults. This includes both the currently drawn amount and any potential future drawdowns on committed credit lines.

27. (A) Safety nets reduce depositor monitoring, which indirectly subsidizes bank risk-taking.
Safety nets such as deposit insurance provide protection for depositors, which can inadvertently reduce their incentive to monitor the bank's financial health. This reduction in external oversight creates a moral hazard, as banks may feel subsidized to take on higher risks with less equity capital. Consequently, the presence of such safety nets often necessitates strict regulatory capital requirements.

28. (A) Going-concern capital absorbs losses during operations, while gone-concern capital does so at liquidation.
Regulatory capital is divided into two main categories based on when it absorbs losses. Going-concern capital, primarily common equity tier one, is designed to absorb losses while the bank continues its normal operations. In contrast, gone-concern capital, such as tier two subordinated debt, is intended to protect depositors and creditors only after the bank has failed and entered liquidation.

29. (C) Term loans to small businesses meeting turnover and granularity criteria.
The regulatory retail portfolio includes specific exposures like term loans to small businesses, provided they meet strict turnover and granularity requirements. Other claims, such as listed equities, mortgage loans under different LTV guidelines, and venture capital investments, are excluded and attract separate risk weights. Therefore, small business term loans that satisfy the necessary regulatory conditions are correctly categorized within this portfolio.

30. (D) DTAs associated with accumulated losses are deducted from Common Equity Tier 1 capital.
Deferred tax assets that rely on the future profitability of the bank to be realized are considered low-quality capital components. Specifically, deferred tax assets associated with accumulated losses must be deducted from common equity tier one capital. This deduction ensures that the bank's most critical capital ratio is not inflated by assets that may have no value during financial distress.

31. (C) Credit Default Swap : Credit of reference entity.
Under the standardized approach for counterparty credit risk, each derivative transaction is assigned a primary risk driver. For credit default swaps, the primary risk driver is the credit quality of the underlying reference entity. This correctly reflects the nature of the contract, where the value depends on the likelihood of a credit event occurring for that specific reference entity.

32. (A) (I), (II) and (IV) only
Calculating common equity tier one capital involves summing positive elements before applying regulatory adjustments. These elements include the stock surplus from common shares, statutory reserves, and realistic revaluation reserves at a fifty-five percent discount. In contrast, items like goodwill and deferred tax assets from losses are negative adjustments that must be deducted from the total capital base rather than included as positive components.

33. (A) P-3, Q-1, R-2, S-4
Tier two debt instruments are subject to a progressive discount as they approach maturity to reflect their diminishing value as capital. Instruments with less than one year remaining receive a hundred percent discount. As the remaining maturity increases from one year up to five years, the discount rate decreases in twenty percent increments, ranging from eighty percent down to twenty percent.

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ANSWERS

1. (C) 2.5% of total RWAs
Under Basel III guidelines adopted by the Reserve Bank of India, banks are required to maintain a capital conservation buffer. This buffer is designed to ensure that banks build up capital reserves during normal times which can be drawn down as losses are incurred during periods of stress. It is set at two point five percent of risk-weighted assets.

2. (C) If specific provisions reach 50% of the outstanding NPA amount, the risk weight is 0%.
Risk weights for non-performing assets depend on the level of specific provisions made. If provisions are less than twenty percent, a higher risk weight applies. Once provisions reach twenty percent, the risk weight reduces significantly. However, a zero percent risk weight is not applicable regardless of the provision level, making the statement regarding a zero risk weight factually incorrect.

3. (C) An RBI-registered market maker that buys government securities to resell them to others.
Primary dealers are specialized financial institutions that act as market makers in the government securities market. They are registered with the Reserve Bank of India and play a crucial role in the primary issuance and secondary market liquidity of sovereign debt. Their participation ensures a stable demand for government bonds and facilitates efficient price discovery within the financial system.

4. (C) It encourages discipline by requiring banks to disclose details of risks, capital, and management.
Market discipline represents the third pillar of the Basel framework, focusing on transparency and public disclosure. By requiring banks to publish details regarding their risk profiles, capital adequacy, and risk management processes, stakeholders can make informed decisions. This transparency encourages banks to maintain sound financial health and prudent management practices through the pressure of market forces and investor scrutiny.

5. (B) It encourages banks to continue improving their internal risk management practices.
The internal ratings-based approach allows banks to use their internal models for calculating capital requirements. This alignment creates a strong incentive for financial institutions to refine their risk assessment methodologies and management practices. By adopting more sophisticated systems, banks can better measure their risk profiles, leading to more accurate capital allocation and improved overall stability within the banking sector.

6. (A) 0%
Direct loan or overdraft exposures of banks to state governments in India are considered to have a very low credit risk. According to the regulatory guidelines issued by the Reserve Bank of India, these specific exposures attract a zero percent risk weight. This treatment reflects the sovereign nature of the obligor and the implicit safety associated with state-level government debt.

7. (B) The accounting residual of assets minus liabilities.
Bank capital serves as a financial cushion to absorb losses and protect depositors. In fundamental accounting terms, it is defined as the residual value that remains after all liabilities are subtracted from total assets. This net worth represents the owners' stake in the institution and provides a critical buffer that ensures the bank remains solvent during periods of financial stress.

8. (B) PFE consists of an aggregate add-on and a multiplier recognizing collateral or negative market value.
Under the standardized approach for counterparty credit risk, the potential future exposure is a key component. It is calculated by combining an aggregate add-on, which represents the potential increase in exposure

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43. (A) (I), (II) and (III) only
The standardized approach for counterparty credit risk calculates exposure at the netting set level using a formula involving replacement cost and potential future exposure. A factor of one point four is applied to this sum. While the multiplier accounts for collateral, it does not reach absolute zero, as the framework maintains a floor to ensure a minimum level of capital is held.

44. (A) (I) and (II) only
Under the foundation internal ratings-based approach, banks provide their own estimates of probability of default while the supervisor provides other inputs. The advanced approach allows banks to estimate all parameters internally. However, it is incorrect to state that India mandated all commercial banks to immediately adopt the advanced approach in 2007, as the transition to sophisticated models is gradual and regulated.

45. (B) INR 300 crore
Claims that are guaranteed by state governments in India attract a standardized risk weight of twenty percent. This risk weight is applied to the total exposure amount to determine the risk-weighted assets. For an exposure of fifteen hundred crore rupees, applying the twenty percent risk weight results in a risk-weighted asset value of three hundred crore rupees for the bank.

46. (A) P-4, Q-3, R-1, S-2
Long-term ratings from domestic agencies map to specific risk weights for corporate exposures. A rating of AAA corresponds to a twenty percent risk weight, while AA attracts thirty percent. An A rating results in a fifty percent risk weight, and BBB rated exposures are assigned a hundred percent risk weight. These weights reflect the increasing credit risk associated with lower credit ratings.

47. (D) Assertion (A) is false, but Reason (R) is true.
Regulatory guidelines generally prohibit banks from using unsolicited ratings for calculating risk-weighted assets to prevent credit rating shopping. A rating is only considered solicited if the issuer has requested and accepted it. Therefore, while the definition of a solicited rating is correct, the assertion that banks are free to use unsolicited ratings is false under current banking regulations.

48. (B) Certain transaction-related contingent items : 20% CCF.
Credit conversion factors are used to determine the credit equivalent of off-balance sheet items. While commitments with certain drawdown and unconditional take-out finance attract a hundred percent factor, and note issuance facilities attract fifty percent, transaction-related contingent items like performance bonds usually attract a fifty percent factor. Therefore, matching them with a twenty percent factor is incorrect according to regulatory standards.

49. (D) (I), (II), (III), (IV) and (V)
Standard supervisory haircuts are applied to various collateral types to account for potential price volatility. These include a zero percent haircut for cash, fifteen percent for gold, and an eight percent haircut for currency mismatches. Highly rated sovereign and securitization exposures also have specific haircuts based on their maturity and credit quality, ensuring a conservative valuation of risk mitigants in capital calculations.

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50. (A) (I) and (II) only
For non-performing assets, specific physical collaterals like land, buildings, and machinery can influence risk weights if they meet strict valuation and age criteria. However, these specific physical assets are not recognized as eligible financial collateral under the standardized approach for performing assets. Therefore, while the first two statements correctly describe the rules for NPAs, the third statement regarding performing assets is incorrect.

51. (D) Yes, turnover is under INR 50 crore and exposure is $\leq 0.2\%$ of retail portfolio.
To qualify for the regulatory retail portfolio, the MSME unit's turnover must be less than fifty crore rupees, which is met at forty-five crore rupees. Additionally, the total exposure must not exceed zero point two percent of the overall retail portfolio. Since six crore rupees is well within the eight crore limit for this specific

facing financial difficulties, protecting both depositors and the broader financial system.

17. (A) Short-term self-liquidating trade letters of credit from movement of goods.
Non-market related off-balance sheet instruments are converted to credit equivalents using specific factors. While items like direct credit substitutes and forward asset purchases attract a hundred percent conversion factor due to their high credit risk, short-term self-liquidating trade letters of credit are treated differently. These instruments carry lower risk and typically attract a much lower factor, such as twenty percent.

18. (D) 150%
For large corporate exposures that remain unrated, regulatory guidelines impose a more conservative risk weight to account for the potential lack of transparency and credit quality assessment. When the aggregate exposure from the banking system to a corporate entity exceeds two hundred crore rupees and is unrated, the applicable risk weight is set at one hundred and fifty percent for capital adequacy.

19. (D) Re-securitisations with a AAA credit rating are considered eligible financial collateral.
The comprehensive approach recognizes various forms of eligible financial collateral, such as cash, gold, and highly-rated securities. However, re-securitisation exposures are generally excluded from being treated as eligible collateral due to their complexity and potential for correlation risk. Therefore, claiming that AAA-rated re-securitisations are eligible financial collateral is incorrect under the prevailing regulatory frameworks for credit risk mitigation.

20. (A) It requires a 25% increase in the risk weight.
Unhedged foreign currency exposure can significantly increase a borrower's credit risk during periods of currency volatility. If the likely loss from such exposure exceeds seventy-five percent of the borrower's earnings before interest and depreciation, the bank must apply an incremental capital requirement. Specifically, this situation mandates a twenty-five percentage point increase in the risk weight applicable to that exposure.

21. (A) II, IV, V, III, I
Calculating potential future exposure add-ons involves a systematic process. The bank first allocates derivative trades to asset classes and then to specific hedging sets. Next, the effective notional amount for every trade is determined based on specific parameters. Hedging set add-ons are then calculated using supervisory factors, and finally, these are aggregated across all sets within the netting set.

22. (C) 5.5%
Under the Basel III capital regulations as implemented by the Reserve Bank of India, banks are required to maintain a minimum level of common equity tier one capital. This high-quality capital must be at least five point five percent of total risk-weighted assets on an ongoing basis. This requirement forms the core part of the bank's regulatory capital structure.

23. (D) Volatility adjustments increase the exposure amount while decreasing the collateral value.
In the comprehensive approach to credit risk mitigation, volatility adjustments or haircuts are applied to both the exposure amount and the collateral value. These adjustments are designed to account for potential future price fluctuations. The haircut increases the value of the exposure while simultaneously decreasing the recognized value of the collateral, ensuring a conservative estimate of the net credit risk.

24. (D) Off-Balance Sheet Unhedged Currency
The internal ratings-based approach categorizes bank exposures into several broad asset classes, such as corporate, sovereign, and retail. Each class has specific risk characteristics and modeling requirements. However, unhedged foreign currency exposure is not a recognized asset class under this framework; rather, it is a risk factor that may influence the risk weighting of existing exposure classes.

25. (B) It must be at least 7% of RWAs before accounting for Common Equity Tier 1.
Additional tier one capital consists of instruments like perpetual non-cumulative preference shares that provide permanent capital to the bank. While these instruments help meet total capital requirements, the statement that they must be at least seven

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the volatility-adjusted exposure amount. The third statement is incorrect because it describes the exposure haircut as a discount factor that decreases the exposure amount.

61. (B) INR 6.0 crore
To find the combined risk-weighted assets, the credit equivalent amounts of both instruments must be multiplied by their respective risk weights. For an unrated corporate claim with a hundred percent risk weight, the RWA equals the credit equivalent amount. Adding five crore rupees for the performance bond and one crore rupees for the trade LC results in a total of six crore rupees.

62. (B) 15%
The level of specific provisions as a percentage of the outstanding NPA amount is a key determinant for assigning risk weights. In this scenario, a specific provision of three crore rupees made against an outstanding balance of twenty crore rupees results in a provision level of fifteen percent. This percentage is then compared against regulatory thresholds to determine the applicable risk weight.

63. (B) INR 4.200 crore
The total risk-weighted asset amount is calculated by summing the drawn portion and the credit equivalent of the undrawn portion, then multiplying by the risk weight. Here, the sum of five point five crore and zero point one crore is five point six crore rupees. Applying the seventy-five percent risk weight for the regulatory retail portfolio results in four point two crore rupees.

64. (C) INR 58.8 crore
The volatility-adjusted value of collateral is calculated by reducing the current market value by the applicable haircut. For state government debt securities valued at sixty crore rupees with a two percent haircut, the reduction amount is one point two crore rupees. Subtracting this from the original value results in a volatility-adjusted collateral value of fifty-eight point eight crore rupees.

65. (B) INR 5 crore
Performance bonds are transaction-related contingent items that are converted into credit equivalents using a specific factor. Under the standardized approach, these instruments typically attract a fifty percent credit conversion factor. Therefore, for a performance bond with a face value of ten crore rupees, the resulting credit equivalent amount is five crore rupees, which is then used for risk weighting.

66. (A) INR 15.0 crore
To calculate the unsecured portion of a non-performing asset net of provisions and collateral, both the specific provision and the eligible financial collateral must be subtracted from the outstanding balance. Starting with twenty crore rupees and subtracting three crore for provisions and two crore for the term deposit collateral leaves a net unsecured portion of fifteen crore rupees.

67. (B) 2%
Standard supervisory haircuts for debt securities depend on the issuer, credit rating, and residual maturity. For securities issued by domestic state governments with a residual maturity of three years, the regulatory framework prescribes a two percent haircut. This adjustment is applied to the collateral value to account for potential interest rate risk and market price fluctuations over time.

68. (B) INR 1.0 crore
Short-term self-liquidating trade letters of credit are used to facilitate the movement of goods and carry a lower risk than other guarantees. Consequently, they are assigned a lower credit conversion factor of twenty percent. For a letter of credit with a face value of five crore rupees, applying this factor results in a credit equivalent amount of one crore rupees.

69. (D) 150%
The risk weight for the net unsecured portion of a non-performing asset is based on the ratio of specific provisions to the outstanding amount. If the specific provisions are fifteen percent, which is less than the twenty percent threshold, the regulatory guidelines mandate a higher risk weight. Specifically, a risk weight of one hundred and fifty percent must be applied to this portion.

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34. (D) Assertion (A) is false, but Reason (R) is true.
Regulatory rules for short-term claims state that unrated exposures must generally be assigned a risk weight one level higher than the risk weight of a rated claim on the same counterparty. However, this does not allow for a risk weight lower than thirty percent. Therefore, while the general principle of the reason is correct, the specific assertion regarding a lower risk weight is false.

35. (A) Only (I) is correct
A maturity mismatch occurs in credit risk mitigation when the residual maturity of the collateral is shorter than the maturity of the underlying exposure. While such collateral can still be recognized, there are strict conditions. Specifically, collateral with an original maturity of less than one year is generally not recognized for credit risk mitigation purposes, making the second statement factually incorrect.

36. (B) INR 150 crore
For fund-based exposures to corporate entities, the risk-weighted asset value is calculated by multiplying the exposure amount by the applicable risk weight. For a long-term AA-rated corporate entity, the standardized risk weight is thirty percent. Thus, for an exposure of five hundred crore rupees, the resulting risk-weighted asset value is one hundred and fifty crore rupees.

37. (A) P-3, Q-1, R-2, S-4
Different exposure classes attract specific risk weights under the standardized approach. Central government guaranteed claims carry a zero percent weight. Claims on specialized institutions like ECGC attract a twenty percent weight. The regulatory retail portfolio is assigned a seventy-five percent weight, while investments in high-risk categories like venture capital funds are subject to a one hundred and fifty percent risk weight.

38. (A) (I), (II) and (III) only
To be included in the regulatory retail portfolio, an exposure must meet specific criteria regarding the nature of the borrower, turnover, and facility type. The borrower must be an individual or a small business with an average annual turnover below fifty crore rupees. However, the maximum exposure to a single counterparty must not exceed seven point five crore rupees, not exceed it.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Higher capital levels align the interests of shareholders with the prudent management of the bank. When equity is low, shareholders have less to lose and may favor excessive risk-taking to achieve high gains. As capital increases, shareholders face greater potential losses from failure, providing a powerful incentive to encourage management to adopt more conservative strategies and maintain stability.

40. (D) Loan INR 30–75 lakh, LTV $>$ 80% : Risk Weight 35%
Risk weights for residential property loans depend on both the loan amount and the loan-to-value ratio. For loans between thirty and seventy-five lakh rupees, a thirty-five percent risk weight is only applicable if the LTV ratio is less than or equal to eighty percent. If the LTV ratio exceeds eighty percent, a higher risk weight would apply, making the stated pair incorrect.

41. (A) INR 0.1 crore
The credit equivalent amount for the undrawn portion of a cash credit facility is calculated by applying a credit conversion factor to the unutilized limit. In this case, the unutilized portion is zero point five crore rupees. Applying a twenty percent conversion factor to this undrawn amount results in a credit equivalent amount of zero point one crore rupees.

42. (A) P-2, Q-4, R-1, S-3
In the internal ratings-based framework, probability of default measures the likelihood of a borrower defaulting within one year. Loss given default represents the percentage of exposure lost upon default. Exposure at default is the estimated amount outstanding at the time of default, and effective maturity is the remaining time until the contractual obligation is fully discharged. These parameters are essential for calculating capital.

NODIA

CHAPTER 26

Capital Allocation Against Market Risk

May/June 2016

1. Omega Bank holds a Government of India bond that matured on 1st January but remains unpaid. By 10th April of the same year, the bank is conducting its risk assessment. How should this specific exposure be treated for capital allocation?

(A) It must attract a specific risk capital charge based on the highest regulatory factor.

(B) It must be slotted into Zone 1 for general market risk measurement.

(C) It requires an alternative total capital charge equal to 100% of its market value.

(D) It will attract capital only for credit risk, treated on par with NPAs.

Oct/Nov 2018

2. How must a bank compute the final total capital charge for market risk for debt securities held under the Available for Sale (AFS) category?

(A) By directly applying the specific risk factor of the HFT category without factoring in general market risk.

(B) By computing the alternative total capital charge and deducting the equivalent general market risk charge.

(C) By selecting the greater of the notionally computed specific risk plus General Market Risk and the alternative total capital charge.

(D) By selecting the lesser of the notionally computed specific risk plus General Market Risk and the alternative total capital charge.

May/June 2007

3. Consider the following positions regarding the scope of the trading book for capital adequacy:

I Securities included under the Held for Trading category.

II Securities included under the Available for Sale category.

III Open gold position limits and open foreign exchange position limits.

IV Derivatives entered into for hedging trading book exposures.

Which combination of the above statements correctly represents items included in the trading book?

(A) (I), (II), and (III) only

(B) (I), (III), and (IV) only

(C) (II), (III), and (IV) only

(D) (I), (II), (III), and (IV)

Oct/Nov 2025

4. In the context of regulatory capital for market risk, consider the following statements:

Assertion (A): For debt securities held under the AFS category, banks must hold a total capital charge for market risk that is equal to the greater of two specific computation methods.

Reason (R): Securities held under the AFS category have a possible longer holding period and attendant higher specific risk compared to HFT securities.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

May/June 2012

5. Match the specific risk capital charge (as % of exposure) for Foreign Central Governments under the HFT category based on their rating:

List I: (Rating)

P. AAA to AA

Q. A to BBB (More than 24 months)

R. BB to B

S. Below B

List II: (Specific Risk Capital Charge)

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Oct/Nov 2009

42. Match the Time Bands to the corresponding Assumed Change in Yield for calculating general market risk:

List I: (Time Bands)

P. 1 to 3 months

Q. 1.9 to 2.8 years

R. 4.3 to 5.7 years

S. 7.3 to 9.3 years

List II: (Assumed Change in Yield)

1. 0.60
2. 0.70
3. 0.80
4. 1.00

(A) P-1, Q-2, R-3, S-4
(B) P-4, Q-3, R-2, S-1
(C) P-3, Q-4, R-1, S-2
(D) P-2, Q-1, R-4, S-3

May/June 2016

43. Consider the following statements regarding equity risk:

I The minimum capital requirement applies to the current market value of equities in the trading book.

II Short equity positions are broadly allowed for banks in India for hedging purposes.

III The specific risk capital charge is 11.25% or as warranted by external rating, whichever is higher.

IV The general market risk charge for equities is set at 9% on the gross equity positions.

Which of the following statements correctly delineate the measurement of Capital Charge for Equity Risk?

(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), and (IV)

Oct/Nov 2018

44. What is the correct prescribed sequential order for determining across-zone disallowances?

I Disallowance across zones 1 and 3.

II Disallowance across zones 1 and 2.

III Disallowance across zones 2 and 3.

(A) (II), (III), (I)
(B) (I), (II), (III)
(C) (III), (II), (I)
(D) (II), (I), (III)

May/June 2007

45. Horizon Bank calculates its aggregate net open position in British Pounds, achieving an actual open position of ₹1,000 crores equivalent. The bank's board-approved internal limit for this currency is ₹800 crores. What is the precise required capital charge for market risk on this foreign exchange position?

(A) ₹72 crores
(B) ₹90 crores
(C) ₹100 crores
(D) ₹112.5 crores

Oct/Nov 2025

46. In the mechanics of the standardised duration method, what is the primary significance of calculating the modified duration for each instrument?

(A) To calculate the exact residual maturity date of the instrument.
(B) To measure the percentage price change of a security resulting from a one percent change in interest rates.
(C) To determine the absolute credit risk spread over the risk-free rate based on the issuer's current credit rating and financial standing.
(D) To adjust the principal repayment based on currency fluctuations.

May/June 2012

47. When computing a bank's net open position in a foreign currency, which methodological step is correct?

(A) Accrued interest should be strictly excluded from the calculation of the net spot position.
(B) The net forward position includes currency futures and principal on swaps not already part of the spot position.
(C) Guarantees certain to be called must be disregarded until final payment is executed.
(D) The net delta-based equivalent of the options book is solely applicable to precious metals and commodity-linked derivatives in the trading book.

NODIA

Oct/Nov 2014

48. In the 1.0 to 1.9 years time slot, a bank calculates its position as having a long position of ₹100 crores (MTM × MD × ACY) and a

(A) Because regulators mandate the netting of intra-day liquidity mismatch against end-of-day equity capital.
(B) Because credit risk parameters require hourly reconciliation with the Held to Maturity portfolio.
(C) Because banks face risks from intra-day movements of market indices to which they are exposed.
(D) Because foreign exchange positions must be cleared through a centralized clearing house strictly by the close of the business day.

May/June 2018

13. Consider the Alternative Total Capital Charge for bonds issued by banks held under the AFS category.
I Applicable Minimum CET1 + CCB = 75% and <100% of applicable CCB.
II Applicable Minimum CET1 + CCB = 0% and <50% of applicable CCB.
III Applicable Minimum CET1 + CCB = 50% and <75% of applicable CCB.
IV Minimum CET1 less than applicable minimum.
V Applicable Minimum CET1 + Applicable CCB and above.
Which of the following conditions correctly attract a 56.25% capital charge for investments in capital instruments (other than equity)?
(A) (I) and (III) only
(B) (II) and (IV) only
(C) (III) and (V) only
(D) (I), (II), and (IV) only

Oct/Nov 2016

14. What is the specific risk capital charge applicable for an exposure to a Foreign Central Government with a rating of AAA to AA?
(A) 0.00%
(B) 0.28%
(C) 1.13%
(D) 1.80%

May/June 2014

15. What is the fundamental conceptual objective behind the capital requirements for general market risk?
(A) To provide capital buffers exclusively for the credit rating downgrades of counterparty issuers.
(B) To measure the probability of operational failure in the trade settlement process.
(C) To ensure that short positions in the equity portfolio provide a comprehensive hedge against long positions in the fixed-income portfolio.
(D) To capture the risk of value loss due to adverse market index changes affecting the investment portfolio.

Oct/Nov 2007

16. From which period were banks required to measure and apply capital charges in respect of their market risks in addition to their credit risks?
(A) From the end of 1995
(B) From the end of 1996
(C) From the end of 1997
(D) From the end of 1999

May/June 2025

17. Match the Rating by the ECAI to the Total capital charge (in %) for the Alternative Total Capital charge for corporate bonds (other than bank bonds) held under the AFS category:
List I: (Rating)
P. AAA
Q. AA
R. A
S. BBB
List II: (Total Capital Charge in %)
1. 4.5%
2. 9.0%
3. 1.8%
4. 2.7%
(A) P-1, Q-2, R-3, S-4
(B) P-3, Q-4, R-1, S-2
(C) P-4, Q-3, R-2, S-1
(D) P-2, Q-1, R-4, S-3

Oct/Nov 2019

18. What is the fundamental design objective of the "specific risk" capital charge?
(A) To protect against price changes in a specific security caused by factors related to the individual issuer.
(B) To capture the risk of loss arising from broad macroeconomic shifts in market interest rates across the banking book.
(C) To measure the probability of default across the entire banking book portfolio over a one-year horizon.

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1. 13.50%
2. 9.00%
3. 0.00%
4. 1.80%

(A) P-2, Q-3, R-1, S-4
(B) P-3, Q-4, R-2, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-1, Q-2, R-4, S-3

Oct/Nov 2014

6. The capital charge for general market risk is calculated as the sum of four distinct components. Which of the following is NOT one of these components?

(A) The net short or long position in the whole trading book.
(B) A large proportion of the matched positions in each time-band known as vertical disallowance.
(C) A larger proportion of the matched positions across different time-bands known as horizontal disallowance.
(D) A net charge for positions in options, where appropriate.

May/June 2019

7. What is the precise definition of market risk as outlined for capital allocation?

(A) The risk of loss arising solely from the default of a counterparty before the final settlement of a transaction.
(B) Potential losses in on-balance and off-balance sheet positions from market price movements.
(C) The risk that an asset cannot be sold quickly enough in the market to prevent a substantial financial loss.
(D) The risk of a sudden decline in net interest margin due to changing central bank policy rates or monetary shifts.

Oct/Nov 2006

8. Identify the correct statement based on the Alternative Total Capital charge for corporate bonds (other than bank bonds) held under the AFS category.

(A) Bonds rated AAA attract a total capital charge of 2.7%.
(B) Bonds rated BBB attract a total capital charge of 9.0%.
(C) Bonds rated AA attract a total capital charge of 4.5%.
(D) Bonds rated BB and below attract a total capital charge of 11.25%.

May/June 2021

9. A bank's trading book includes a Government of India (GOI) Bond held under the HFT category with a market value of ₹150 crores and a residual maturity of 4 months. What is the calculated specific risk capital charge for this GOI Bond?

(A) NIL
(B) ₹0.42 crores
(C) ₹1.695 crores
(D) ₹2.70 crores

Oct/Nov 2010

10. What defines the "General market risk" charge in the measurement of interest rate risk?

(A) A charge calculated as the net delta-based equivalent of the total book of foreign currency options.
(B) A charge applied exclusively to non-convertible preference shares held in the banking book.
(C) A charge designed to capture the risk of loss arising from changes in market interest rates.
(D) A charge intended to protect against adverse price movements linked directly to the individual issuer's credit rating.

NODIA

May/June 2005

11. Evaluate the following statements regarding the methodologies for measuring market risk:

I The Basel Committee has suggested two broad methodologies: the standardised method and the banks' internal risk management models method.
II As banks in India are still in a nascent stage of developing internal risk management models, they are mandated to adopt only the standardised method to start with.

Which of the statements is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2022

12. Why are banks required to maintain strict risk management systems to monitor and control intra-day exposures to market risks?

May/June 2020

25. Identify the INCORRECT statement regarding the specific risk capital charge for bonds issued by All Scheduled Banks held under the HFT category.
(A) For a residual maturity of 6 months or less, the charge for all other claims is 0.28%.
(B) For a residual maturity of 6 months or less, the charge for investments in capital instruments is 7.06%.
(C) For a residual maturity of more than 24 months, the charge for all other claims is 1.8%.
(D) For a residual maturity of more than 6 months and up to 24 months, the charge for investments in capital instruments is 7.06%.

Oct/Nov 2015

26. Which of the following is NOT included in the scope and coverage of capital charge for market risks?
(A) Securities included under the Available for Sale category.
(B) Open foreign exchange position limits.
(C) Trading positions in derivatives.
(D) Securities included under the Held to Maturity category.

May/June 2013

27. When computing the specific risk for securities held under the AFS category, consider the following procedures:
I Compute the alternative total capital charge treating the securities as held in the banking book.
II Compute the specific risk capital charge notionally by treating the securities as held under the HFT category.
III Multiply the alternative total capital charge by the general market risk charge to arrive at the final value.
IV Determine the final capital charge for specific risk under AFS as the greater of the alternative total capital charge or the combined notional HFT specific risk plus General Market Risk charge.
Which of the following procedures must be followed?
(A) (I), (II), and (IV) only
(B) (I), (II), and (III) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

Oct/Nov 2021

28. Consider the following statements regarding specific risk and market positions:
I A short position is generally not allowed in India except in derivatives and Central Government Securities.
II For debt securities held under the AFS category, banks must hold a total capital charge equal to the lesser of the specific risk capital charge or the alternative total capital charge.
Which of the statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2024

29. Arrange the following steps in the correct chronological sequence to estimate the capital charge necessary for Specific Risk in respect of exposures in the HFT category:
I Segregate the instruments held under HFT category.
II Calculate the capital charge for specific risk under HFT category by applying the appropriate factor.
III Find out the relevant Specific Risk capital charge factor by referring to the prescribed regulatory tables.
IV Compute the residual period to maturity.
(A) (I), (IV), (III), (II)
(B) (IV), (I), (II), (III)
(C) (I), (III), (IV), (II)
(D) (III), (I), (IV), (II)

Oct/Nov 2008

30. Which of the following correctly pairs the nature of investment by Indian Central and State Governments with its corresponding specific risk capital charge under the HFT category?
(A) Investment in Central Government Securities : 0.28%
(B) Investments in other approved securities guaranteed by State Government (More than 24 months) : 1.13%
(C) Investments in other approved securities guaranteed by State Government (6 months or less) : 0.00%

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(D) Investments in other approved securities guaranteed by Central Government : 0.00%

May/June 2006

31. In the context of market risk disallowance factors, consider the following statements:
Assertion (A): The matched position within the same time bucket is subjected to a vertical disallowance of 5%.
Reason (R): This vertical disallowance serves as additional capital required for taking care of yield curve risk across different maturity zones.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2017

32. A commercial bank has a direct investment exposure to equity shares in its HFT category with a market value of ₹700 crores. Assuming no alternative external rating constraints apply, what are the respective capital charges for Specific Risk and General Market Risk?
(A) Specific Risk: ₹63.00 crores; General Market Risk: ₹78.75 crores
(B) Specific Risk: ₹78.75 crores; General Market Risk: ₹63.00 crores
(C) Specific Risk: ₹56.25 crores; General Market Risk: ₹45.00 crores
(D) Specific Risk: ₹11.25 crores; General Market Risk: ₹9.00 crores

May/June 2008

33. Arrange the following steps in the correct chronological order to measure the general market risk charge under the duration method:
I Slot the securities into a maturity ladder containing 15 time bands.
II Multiply the marked to market value of each security by its modified duration and assumed change in yield.
III Compute the Marked to Market value and compute the residual period to maturity.
IV Multiply the assumed change in yield by the modified duration to find the interest rate sensitivity.
(A) (I), (III), (IV), (II)
(B) (III), (I), (IV), (II)
(C) (III), (IV), (I), (II)
(D) (I), (II), (III), (IV)

Oct/Nov 2013

34. A bank determines its net open position in each foreign currency by summing various elements. Which of the following is NOT typically one of those summed elements?
(A) The net spot position comprising all asset items less all liability items, including accrued interest.
(B) The net forward position, including amounts to be received less amounts to be paid.
(C) Guarantees that are certain to be called and are likely to be irrecoverable.
(D) Outstanding principal of all domestic retail loans denominated in local currency.

NODIA

May/June 2015

35. Consider the following statements concerning the calculation of yield curve risk exposures and horizontal disallowance:
I Net positions in each time-band are carried forward for horizontal offsetting.
II Horizontal disallowance addresses yield curve risk arising from imperfect correlation of interest rates across different time horizons.
III An implied assumption in allowing offsets is that interest rate movements are perfectly correlated, representing a constant yield curve shift.
IV Horizontal disallowance accounts for basis risk by disallowing a portion of offset amounts within the same time bucket.
V The farther apart the time bands, the greater the add-on arising from imperfect correlation along the yield curve.
Which combinations of the above statements are true?
(A) (I), (II), (III), and (V)
(B) (I), (II), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

Oct/Nov 2012

36. A bank calculates a net spot position in Japanese Yen comprised of ₹500 crores in asset items and ₹300 crores in liability items. Concurrently, the bank holds a net forward position of ₹(100) crores (indicating more amounts to be paid than received). Assuming no other instruments, what is the net open position used to calculate the foreign exchange risk capital charge?
(A) ₹100 crores
(B) ₹200 crores
(C) ₹300 crores
(D) ₹400 crores

May/June 2011

37. What is the precise definition of Vertical Disallowance in the context of capital allocation against market risk?
(A) The risk that price relationships between similar instruments in the same time zone vary over time, capturing basis risk.
(B) It captures the imperfect correlation of interest rates along the yield curve applicable to securities in different time zones.
(C) It is the net forward position of all asset items less all liability items denominated in foreign currency.
(D) An automatic 100% capital requirement applied to all unmatched and residual positions across Zone 1 and Zone 3 to mitigate systemic volatility.

Oct/Nov 2020

38. Match the Time Zone with the upper boundary of its included time bands under the Duration Method:
List I: (Time Zone metrics)
P. Maximum maturity bound for Zone 1
Q. Maximum maturity bound for Zone 2
R. Maximum maturity bound for Zone 3
S. Total number of time bands prescribed
List II: (Boundary / Quantity)
1. 3.6 years
2. 12 months
3. 15 bands
4. Over 20 years
(A) P-1, Q-2, R-3, S-4
(B) P-3, Q-4, R-1, S-2
(C) P-2, Q-1, R-4, S-3
(D) P-4, Q-3, R-2, S-1

May/June 2022

39. In the context of equity trading by financial institutions, consider the following statements:
Assertion (A): In India, banks compute specific risk on gross equity positions, summing all long equity positions without offsetting any short equity positions.
Reason (R): The creation of a short equity position is not allowed for banks in India.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2023

40. After netting all individual positions within the time slots of Zone 1, a bank arrives at a total long position of ₹235 crores and a total short position of ₹(100) crores. What is the horizontal within-zone disallowance capital charge for Zone 1?
(A) ₹13.50 crores
(B) ₹30.00 crores
(C) ₹40.00 crores
(D) ₹54.00 crores

May/June 2023

41. Which of the following best defines the concept of "Basis Risk" within the context of general market risk?
(A) The risk that an entire yield curve will uniformly shift downward leading to capital erosion.
(B) The risk that the price relationship between similar instruments in the same time zone is not stable over time.
(C) The risk of a significant counterparty defaulting prior to the final settlement of a multi-currency interest rate swap agreement.
(D) The risk associated with the translation of foreign currency balance sheet items into domestic currency.

NODIA

of the specific time bands are perfectly correlated with one another.
(B) That yield curves will immediately invert during a macroeconomic crisis.
(C) That long and short positions inherently negate issuer-specific credit risk.
(D) That liquidity premiums and bid-ask spreads remain fixed and predictable regardless of the instrument's maturity or market depth.

Oct/Nov 2016

56. Which of the following correctly pairs the Time Zone with its corresponding Within-zone disallowance factor?
(A) Zone 1 : 30%
(B) Zone 2 : 40%
(C) Zone 3 : 30%
(D) Zone 1 and 2 : 100%

May/June 2014

57. Evaluate the following statements regarding the capital charge for market risks in foreign exchange:
I The capital charge for open positions, whether limits or actual whichever is higher, is evaluated at 9%.
II This capital charge is in addition to the capital charge for credit risk on the on-balance sheet and off-balance sheet items pertaining to foreign exchange transactions.
Which of the statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2007

58. A bank carries forward a residual long position of ₹135 crores from Zone 1 and a residual short position of ₹(150) crores from Zone 2. Calculate the across-zone horizontal disallowance capital charge between Zone 1 and Zone 2.
(A) ₹54.00 crores
(B) ₹60.00 crores
(C) ₹135.00 crores
(D) ₹150.00 crores

May/June 2025

59. Identify the strictly INCORRECT statement regarding the application of the capital charge for equity risk.
(A) It applies to all instruments that exhibit market behavior similar to equities.
(B) It covers equity shares, irrespective of whether they are voting or non-voting.
(C) It includes non-convertible preference shares held within the trading book.
(D) It includes all firm commitments to buy or sell equity instruments in the future, regardless of the settlement date.

Oct/Nov 2019

60. In determining horizontal disallowance, across-zone adjustments follow a strict order. Which of the following is NOT part of this standard regulatory sequence?
(A) Disallowance across zones 1 and 2.
(B) Disallowance across zones 2 and 3.
(C) Disallowance across zones 3 and 4.
(D) Disallowance across zones 1 and 3.

May/June 2009

61. Consider the following procedures for arriving at the net capital requirement for General Market Risk:
I The estimated interest exposure can be positive or negative when exposed to both short and long positions in trading activities.
II Long and short positions are netted subject directly to disallowance provisions to arrive at the net capital requirement.
III The gross positions in each time-band are subjected to an assumed change in yield, with full offsetting permitted unconditionally across all foreign currencies.
Which of the above procedures accurately depict the netting process?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2011

62. Which of the following statements correctly pairs the regulatory capital requirement with its primary protective function?
(A) General Market Risk capital charge is

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short position of ₹(150) crores. What is the calculated vertical disallowance capital charge for this specific time bucket?
(A) ₹2.50 crores
(B) ₹5.00 crores
(C) ₹7.50 crores
(D) ₹12.50 crores

May/June 2019

49. Nexus Bank manages a trading portfolio holding equity shares valued at ₹500 crores in the AFS category and ₹700 crores in the HFT category. Calculate the aggregate total capital charge (combining both specific and general market risks) for this entire equity exposure.
(A) ₹108 crores
(B) ₹135 crores
(C) ₹243 crores
(D) ₹270 crores

Oct/Nov 2006

50. What best differentiates the fundamental purpose of vertical disallowance from horizontal disallowance?
(A) Vertical disallowance captures yield curve risk, while horizontal disallowance captures credit risk.
(B) Vertical disallowance is assessed at a 40% rate, while horizontal disallowance operates at a flat 5% rate across all time bands.
(C) Vertical disallowance captures basis risk within a time zone; horizontal captures imperfect interest rate correlation across zones.
(D) Vertical disallowance is applied strictly to equity portfolios to manage volatility, whereas horizontal disallowance is restricted to managing global foreign exchange exposures.

May/June 2021

51. Consider the following items used to calculate a bank's net open position in a foreign currency:
I The net spot position comprising all asset items less all liability items, including accrued interest.
II The net forward position comprising amounts to be received less amounts to be paid.
III Guarantees that are certain to be called and are likely to be irrecoverable.
IV Net future income/expenses not yet accrued but already fully hedged.
V Non-convertible preference shares issued in domestic currency.
Which of the following items are properly summed for the calculation?
(A) (I), (II), (III), and (IV)
(B) (I), (II), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

Oct/Nov 2010

52. A bank holds a corporate bond in its trading book within the 9.3 to 10.6 years time band (Zone 3). The market value is ₹200 crores, and the modified duration is 7.5 years. Based on the duration method, what is the initial capital charge component for general market risk before applying any disallowances?
(A) ₹6.00 crores
(B) ₹9.00 crores
(C) ₹11.25 crores
(D) ₹15.00 crores

May/June 2005

53. Which of the following incorrectly pairs the Across-zone disallowance with its prescribed Disallowance factor?
(A) Zone 1 and 2 : 40%
(B) Zone 2 and 3 : 40%
(C) Zone 1 and 3 : 50%
(D) Zone 1 and 3 : 100%

Oct/Nov 2022

54. What is the current prescribed risk weight and the resulting capital charge for foreign exchange open positions and gold open positions?
(A) Risk-weighted at 50%; Capital charge is 4.5%
(B) Risk-weighted at 100%; Capital charge is 9%
(C) Risk-weighted at 125%; Capital charge is 11.25%
(D) Risk-weighted at 150%; Capital charge is 13.5%

May/June 2018

55. When full offsetting of long and short positions is allowed in the measurement framework, what is the crucial underlying implied assumption?
(A) That interest rate movements within each

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(D) To offset matched long and short positions in different securities across time zones and trading desks.

May/June 2009

19. A bank holds an investment in approved securities guaranteed by a State Government under the HFT category. The market value is ₹100 crores, and the residual maturity is 15 months. What will be the specific risk capital charge?
(A) ₹0.00 crores
(B) ₹0.28 crores
(C) ₹1.13 crores
(D) ₹1.80 crores

Oct/Nov 2011

20. Which of the following pairs regarding the Specific Risk Capital Charge for corporate bonds (other than bank bonds) held under the HFT category is strictly INCORRECT?
(A) BB and below (All maturities) : 9.00%
(B) AAA to BBB (6 months or less) : 0.28%
(C) AAA to BBB (More than 24 months) : 1.80%
(D) Unrated, if permitted (All maturities) : 9.00%

May/June 2010

21. Regarding the treatment of currencies in the measurement of general market risk, identify the correct statement.
(A) Time bands offsetting between positions of opposite sign across different currencies is fully permitted without restriction.
(B) All net long and short positions for all currencies must be offset globally to produce a single gross position figure.
(C) Separate calculations for a currency are optional if its turnover is under 5% of total foreign exchange turnover.
(D) Modified duration should be calculated using a unified yield curve methodology regardless of the currency denomination or regional economic factors.

Oct/Nov 2024

22. In the context of risk management and capital allocation, consider the following statements:
Assertion (A): Capital for market risk would not be relevant for securities which have already matured and remain unpaid.
Reason (R): On completion of 90 days delinquency, these securities will be treated on par with NPAs for deciding the appropriate risk weights for credit risk.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2017

23. Regarding the capital charge for debt securities held under the Available for Sale (AFS) category, consider the following statements:
I The specific risk capital charge is computed notionally for the AFS securities treating them as held under the Held for Trading (HFT) category.
II The General Market Risk Capital charge is added to the notionally computed specific risk capital charge.
III The alternative total capital charge for the AFS category is computed notionally treating them as held in the trading book.
Which of the following combinations of statements is correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2005

24. Zenith Bank holds Corporate Bonds rated AAA in its AFS portfolio. The market value of these bonds is ₹200 crores, and the residual maturity is 4 months. When computing the specific risk capital charge notionally by treating the security as held under HFT, what is the resulting specific risk capital charge amount?
(A) ₹0.00 crores
(B) ₹0.56 crores
(C) ₹2.28 crores
(D) ₹3.60 crores

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expected to protect the bank against interest rate risk.
(B) Capital charge for Specific Market Risk is expected to protect against interest rate risk.
(C) Horizontal disallowance is explicitly meant to take care of basis risk.
(D) Vertical disallowance is a regulatory requirement meant to take care of yield curve risk across different maturity zones within the bank.

May/June 2010

63. In the context of capital allocation against market risk for a stock portfolio, what accurately defines a "Short Position"?
(A) Stocks and other equity-linked instruments that have been purchased outright and are currently owned by the financial institution for long-term holding.
(B) An exposure created when a trader buys a security on margin with the intention of holding it long term.
(C) Selling a security with the intention of repurchasing it later at a lower price to close the position.
(D) A position resulting exclusively from the unwinding of a non-convertible preference share.

Oct/Nov 2024

64. Vanguard Bank holds an inventory of debt securities in its AFS portfolio. The bank determines that the specific risk capital charge computed notionally (treating them as HFT) is ₹30 crores. The General Market Risk Capital Charge assigned to these securities is ₹15 crores. The Alternative Total Capital Charge, computed by treating the AFS securities as held in the banking book, amounts to ₹40 crores. What final total capital charge must the bank allocate for market risk on these AFS debt securities?
(A) ₹30 crores
(B) ₹40 crores
(C) ₹45 crores
(D) ₹55 crores

May/June 2017

65. Following the 1996 amendment to the Basel I Accord, what represents the primary rationale for mandating banks to maintain capital against market risk?
(A) To strictly prohibit banks from accumulating any sovereign exposures in the trading book.
(B) To insulate market players against losses by mandating capital provisions for manifest trading-related risks.
(C) To eliminate the dependency on external credit rating agencies for assessing the riskiness of the entire HFT portfolio on a daily basis.
(D) To ensure that banks merge their trading books and banking books for unified liquidity coverage.

Oct/Nov 2005

66. Based on the fundamental premises of market risk allocation, identify the strictly INCORRECT statement:
(A) Capital charge for General Market Risk is expected to protect the bank against interest rate risk.
(B) Horizontal disallowance is meant to take care of yield curve risk.
(C) Vertical disallowance is a mechanism specifically meant to take care of the basis risk inherent in matching different instruments.
(D) Specific Risk capital charge is expected to protect against liquidity risk.

May/June 2020

67. A bank calculates its exposure to yield curve risk. Within a designated time band, it documents a long position of ₹500 crores and a short position of ₹200 crores. After determining the matched offsetting portion for vertical disallowance, what exact residual position will be carried forward for across-zone horizontal offsetting?
(A) ₹200 crores (long)
(B) ₹300 crores (long)
(C) ₹500 crores (long)
(D) ₹700 crores (long)

Oct/Nov 2015

68. Identify the INCORRECT statement concerning the operational directives for market risk management.
(A) Banks must mark to market their trading positions weekly to align with regulatory

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reporting cycles.

(B) Banks must manage market risks in their books on an ongoing basis.

(C) Banks must ensure capital requirements for market risks are maintained continuously at the close of each business day.

(D) Banks must maintain robust and strict risk management systems to monitor and control intra-day exposures to various market risks across all portfolios.

May/June 2013

69. Match the specific regulatory mechanism to the corresponding risk it is explicitly designed to mitigate:

List I: (Mechanism)

P. General Market Risk Capital Charge

Q. Specific Market Risk Capital Charge

R. Horizontal Disallowance

S. Vertical Disallowance

List II: (Risk Mitigated)

1. Issuer Risk
2. Basis Risk
3. Yield Curve Risk
4. Interest Rate Risk

(A) P-1, Q-4, R-2, S-3

(B) P-4, Q-1, R-3, S-2

(C) P-3, Q-2, R-1, S-4

(D) P-2, Q-3, R-4, S-1

Oct/Nov 2021

70. During the final phase of calculating horizontal disallowance, a bank determines it has a residual long position of ₹300 crores in Zone 2 and a residual short position of ₹(15) crores in Zone 3. The matched offsetting position across Zone 2 and Zone 3 is verified as ₹15 crores. Based on the mandated disallowance factor for these adjacent zones, what is the precise capital charge incurred for this across-zone disallowance?

(A) ₹6.00 crores

(B) ₹10.50 crores

(C) ₹15.00 crores

(D) ₹30.00 crores

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1. (D) It will attract capital only for credit risk, treated on par with NPAs.
Securities that remain unpaid after maturity are treated as non-performing assets for capital purposes. Once a bond matures and is not paid, market risk capital charges are no longer applicable. Instead, the exposure is shifted to the banking book and risk-weighted according to credit risk guidelines, similar to other non-performing loans and assets.

2. (C) By selecting the greater of the notionally computed specific risk plus General Market Risk and the alternative total capital charge.
Banks determine the final market risk capital charge for debt securities held in the Available for Sale category by comparing two figures. They compute the sum of specific risk and general market risk charges notionally as if held for trading. The higher value between this sum and the alternative total capital charge based on banking book rules is selected.

3. (D) (I), (II), (III), and (IV)
The trading book for regulatory capital purposes includes various instruments intended for active trading or hedging. This encompasses securities classified as Held for Trading and Available for Sale. Additionally, open gold and foreign exchange position limits are included. Derivatives used to hedge exposures within the trading book also fall under this category to ensure comprehensive risk coverage.

4. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Regulatory requirements mandate that securities in the Available for Sale category attract a capital charge equal to the greater of the market risk or banking book charges. This ensures a conservative approach to risk management. Since these securities may be held for longer periods than trading assets, they carry higher specific risks, justifying this specific prudential capital treatment.

5. (B) P-3, Q-4, R-2, S-1
Specific risk capital charges for foreign central governments are determined by their external ratings. Governments rated AAA to AA attract a zero percent charge. Those rated A to BBB with long maturities carry a one point eight percent charge. Ratings of BB to B result in a nine percent charge, while ratings below B require thirteen point five percent.

6. (B) A large proportion of the matched positions in each time-band known as vertical disallowance.
General market risk calculation involves four primary components to capture interest rate fluctuations. These include the net position across the whole trading book and charges for options. Horizontal disallowance addresses risks across different time bands. However, vertical disallowance applies only to matched positions within each time band to account for basis risk rather than general market movements.

7. (B) Potential losses in on-balance and off-balance sheet positions from market price movements.
Market risk is defined as the potential for financial loss in on-balance sheet and off-balance sheet positions due to movements in market prices. This encompasses risks associated with interest rate related instruments and equities in the trading book. It also includes foreign exchange risk and gold positions across the entire bank, reflecting overall volatility in market variables.

8. (B) Bonds rated BBB attract a total capital charge of 9.0%.
Under the alternative total capital charge framework for Available for Sale corporate bonds, capital requirements are linked to external ratings. Bonds rated BBB are assigned a risk weight that translates to a nine percent total capital charge. This ensures that credit risk is appropriately cushioned for securities held outside the Held for Trading portfolio but within the market risk scope.

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45. (B) ₹90 crores
Capital for foreign exchange risk is calculated on the higher of the actual net open position or the board-approved limit. Here, the actual position of one thousand crores is greater than the eight hundred crore limit. A nine percent capital charge is applied to this amount. Therefore, the bank must maintain ninety crores in capital for its British Pound exposure.

46. (B) To measure the percentage price change of a security resulting from a one percent change in interest rates.
Modified duration is a critical metric used to estimate the price sensitivity of a debt instrument to changes in interest rates. It represents the approximate percentage change in the security's value for a one percent shift in yield. By using this measure, the standardised duration method provides a more accurate assessment of general market risk compared to simple maturity-based approaches.

47. (B) The net forward position includes currency futures and principal on swaps not already part of the spot position.
When calculating the net open position in a foreign currency, banks must include the net forward position. This component encompasses all forward transactions, including currency futures and the principal amounts of currency swaps that have not been accounted for in the spot position. This ensures that future commitments and hedging activities are properly reflected in the overall currency risk exposure.

48. (B) ₹5.00 crores
Vertical disallowance is calculated as five percent of the matched long and short positions within a specific time band. In this bucket, the bank has a long position of one hundred crores and a short position of one hundred fifty crores. The matched portion is one hundred crores. Applying the five percent factor to this matched amount results in a five crore charge.

49. (C) ₹243 crores
The total capital charge for equity consists of an eleven point twenty-five percent specific risk charge and a nine percent general market risk charge on the risk-weighted position. For a total portfolio of one thousand two hundred crores, specific risk is one hundred thirty-five crores. General market risk on the risk-weighted exposure equals one hundred eight crores. Summing these gives two hundred forty-three crores.

50. (C) Vertical disallowance captures basis risk within a time zone; horizontal captures imperfect interest rate correlation across zones.
Vertical disallowance and horizontal disallowance serve different regulatory purposes. Vertical disallowance addresses basis risk, which arises from imperfect price correlations between different instruments held within the same time band. Conversely, horizontal disallowance captures yield curve risk, which reflects the imperfect correlation of interest rate movements across different time zones or maturity buckets along the entire yield curve.

51. (A) (I), (II), (III), and (IV)
The calculation of a bank's net open position in a foreign currency is a comprehensive process. It sums the net spot position including accrued interest and the net forward position. It also includes guarantees that are certain to be called and irrecoverable. Finally, it accounts for future income or expenses that have not yet accrued but are already fully hedged.

52. (B) ₹9.00 crores
To find the initial general market risk charge, the bank multiplies the market value by the modified duration and the assumed change in yield. For this Zone 3 bond, the calculation is two hundred crores multiplied by seven point five years and an assumed yield change of zero point six percent. This result is a nine crore initial capital charge component.

53. (C) Zone 1 and 3 : 50%
Across-zone disallowance factors are set based on the distance between maturity zones. Offsetting between the adjacent Zone 1 and Zone 2, as well as Zone 2 and Zone 3, attracts a forty percent charge. However, offsetting positions between the non-adjacent Zone 1 and Zone 3 is subject to a higher one hundred percent disallowance factor, reflecting lower interest rate correlation.

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18. (A) To protect against price changes in a specific security caused by factors related to the individual issuer.
The specific risk capital charge is designed to protect a bank against price fluctuations in an individual security. These changes are typically driven by factors unique to the issuer, such as changes in credit quality or financial performance. It ensures the bank holds enough capital to cover risks that are independent of broad movements in market interest rates or indices.

19. (C) ₹1.13 crores
Approved securities guaranteed by State Governments are subject to specific risk charges based on their residual maturity. For a bond with a maturity of fifteen months, which falls in the bracket of six to twenty-four months, the prescribed factor is one point thirteen percent. Applying this factor to a market value of one hundred crores results in a charge.

20. (A) BB and below (All maturities) : 9.00%
Specific risk charges for corporate bonds held for trading are determined by their ratings and residual maturities. For bonds rated AAA to BBB, charges vary from zero point twenty-eight percent for short maturities to one point eight percent for longer ones. However, bonds rated BB and below carry a higher specific risk capital charge of thirteen point five percent.

21. (C) Separate calculations for a currency are optional if its turnover is under 5% of total foreign exchange turnover.
In the measurement of general market risk, banks must perform separate calculations for each currency that constitutes a significant portion of their business. If a specific currency's turnover is less than five percent of the total foreign exchange turnover, a separate calculation is not mandatory. This threshold simplifies the risk measurement process for currencies with minor transaction volumes.

22. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
When a security matures and remains unpaid, it is no longer considered a trading instrument subject to market risk. After a delinquency period of ninety days, it is classified as a non-performing asset. Consequently, the capital treatment shifts from market risk to credit risk, where appropriate risk weights are applied to the exposure based on its non-performing status.

23. (A) (I) and (II) only
To determine the capital charge for Available for Sale debt securities, banks perform a dual calculation. First, they calculate the specific risk capital charge notionally as if the securities were held for trading. Second, they add the general market risk charge to this notional specific risk. These two steps together form part of the assessment for the final capital requirement.

24. (B) ₹0.56 crores
For a corporate bond rated AAA with a residual maturity of four months, the notional specific risk factor is zero point twenty-eight percent. When calculating this for an exposure of two hundred crores, the result is zero point fifty-six crores. This computation treats the Available for Sale security as if it were part of the Held for Trading portfolio.

25. (B) For a residual maturity of 6 months or less, the charge for investments in capital instruments is 7.06%.
Capital instruments issued by banks have specific risk charges determined by maturity and the issuer's capital position. For claims other than capital instruments, the charge is zero point twenty-eight percent for short maturities and one point eight percent for long ones. The charge for investments in capital instruments is actually nine percent, rather than seven point zero six percent.

26. (D) Securities included under the Held to Maturity category.
The scope of capital charges for market risk covers instruments held with trading intent or as hedges. This includes securities in the Held for Trading and Available for Sale categories, along with foreign exchange and gold positions. Securities in the Held to Maturity category are excluded from market risk capital charges as they are intended to be held until they mature.

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63. (C) Selling a security with the intention of repurchasing it later at a lower price to close the position.
A short position in an equity portfolio is created when an investor sells a security that they do not currently own. The intention is to repurchase the security at a later time, ideally at a lower price, to return it to the lender and profit from the price decline. This is the opposite of a long position, where securities are owned outright.

64. (C) ₹45.00 crores
To find the final capital charge for Available for Sale debt securities, the bank compares the sum of notional market risk charges and the alternative total capital charge. Here, the sum of notional specific risk and general market risk is forty-five crores. Since this is higher than the forty crore alternative total capital charge, the bank must allocate forty-five crores.

65. (B) To insulate market players against losses by mandating capital provisions for manifest trading-related risks.
The primary reason for mandating capital against market risk is to ensure that banks have a sufficient financial cushion to absorb potential losses from their trading activities. By requiring capital provisions for risks inherent in market price movements, regulators aim to maintain the stability of individual banks and the overall financial system, especially as trading portfolios grow in size and complexity.

66. (D) Specific Risk capital charge is expected to protect against liquidity risk.
The market risk framework is designed to address specific types of volatility. General market risk protects against interest rate changes, while horizontal and vertical disallowances manage yield curve and basis risks, respectively. The specific risk capital charge is intended to protect against price movements caused by the credit quality of the issuer, rather than being a buffer for general liquidity risk.

67. (B) ₹300 crores (long)
Within a time band, a bank first nets its long and short positions. With five hundred crores long and two hundred crores short, the matched portion is two hundred crores, which is used for the vertical disallowance calculation. The remaining three hundred crores is the residual long position. This residual amount is then carried forward for further offsetting in the horizontal disallowance process across zones.

68. (A) Banks must mark to market their trading positions weekly to align with regulatory reporting cycles.
Regulatory guidelines require banks to manage and monitor their market risk exposures on an ongoing basis. This includes maintaining capital requirements at the close of every business day. Banks must also have robust systems for controlling intra-day exposures. However, positions in the trading book must be marked to market daily, rather than weekly, to reflect current market values and risk profiles accurately.

69. (B) P-4, Q-1, R-3, S-2
Each component of the market risk framework addresses a different risk. The general market risk charge mitigates interest rate risk. Specific risk is designed for issuer risk. Horizontal disallowance accounts for yield curve risk due to imperfect correlations across maturities. Vertical disallowance is used to manage basis risk, which is the imperfect price correlation between instruments within the same maturity bucket.

70. (A) ₹6.00 crores
The across-zone disallowance between adjacent zones like Zone 2 and Zone 3 is forty percent. In this scenario, the matched offsetting position between the two zones is fifteen crores. Applying the forty percent disallowance factor to this matched amount results in a capital charge of six crores. This charge accounts for the risk that interest rate movements across these zones are not perfectly correlated.

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36. (A) ₹100 crores
The net open position is calculated by combining the net spot position and the net forward position. In this case, the spot position is a surplus of two hundred crores, while the forward position is a deficit of one hundred crores. Summing these results in a net open position of one hundred crores, which serves as the basis for the capital charge.

37. (A) The risk that price relationships between similar instruments in the same time zone vary over time, capturing basis risk.
Vertical disallowance is a regulatory mechanism designed to capture basis risk within the interest rate risk framework. It accounts for the risk that the price relationship between different instruments in the same time band may change over time. By applying a five percent charge on matched positions within a bucket, it ensures capital is held for these potential price discrepancies.

38. (C) P-2, Q-1, R-4, S-3
The duration method uses a maturity ladder with fifteen time bands. Zone 1 includes bands with maturities up to twelve months. Zone 2 covers maturities up to three point six years. Zone 3 encompasses all maturities over three point six years up to those exceeding twenty years. This structured approach allows for systematic measurement of interest rate sensitivity and offsetting.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
In India, banks are generally not permitted to create short positions in the equity market. Because of this restriction, they cannot offset long equity positions with short ones when calculating specific risk. Consequently, banks must compute the specific risk capital charge based on their gross equity positions, ensuring a conservative capital buffer against individual stock price volatility and issuer risk.

40. (C) ₹40.00 crores
Within Zone 1, the horizontal disallowance factor is forty percent of the matched long and short positions. With a long position of two hundred thirty-five crores and a short position of one hundred crores, the matched amount is one hundred crores. Applying the forty percent factor to this matched portion results in a capital charge of forty crores for the bank.

41. (B) The risk that the price relationship between similar instruments in the same time zone is not stable over time.
Basis risk is the uncertainty that the price relationship between two similar financial instruments will not remain stable over time. Within the market risk framework, it specifically refers to the risk that occurs when offsetting positions in the same time band do not move in perfect unison. This requires banks to hold capital even when their interest rate exposures are matched.

42. (B) P-4, Q-3, R-2, S-1
The general market risk framework assigns an assumed change in yield to different time bands based on volatility. For shorter maturities like one to three months, the factor is one point zero zero. Bands between one point nine and two point eight years use zero point eighty. Maturing between four point three and five point seven years uses zero point seventy.

43. (B) (I), (III), and (IV)
The capital requirement for equity risk is based on the current market value of equities in the trading book. Specific risk is generally eleven point twenty-five percent of the gross position. General market risk is nine percent of the risk-weighted position. While short positions are largely restricted in India, these charges together provide a comprehensive buffer against both issuer and market volatility.

44. (A) (II), (III), (I)
The regulatory process for calculating horizontal disallowance follows a specific sequence for offsetting residual positions across zones. First, the bank offsets remaining positions between Zone 1 and Zone 2. Second, it performs the offset between Zone 2 and Zone 3. Finally, any remaining positions between Zone 1 and Zone 3 are matched, with each step attracting its respective disallowance capital factor.

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9. (A) NIL
Specific risk capital charges are intended to protect against price changes caused by issuer-related factors. For Government of India securities, the regulatory framework assigns a zero percent specific risk charge. Regardless of the market value or the residual maturity of the bond, these sovereign exposures do not attract any capital requirement for specific risk in the bank's trading book.

10. (C) A charge designed to capture the risk of loss arising from changes in market interest rates.
The general market risk charge is a regulatory requirement designed to capture the risk of financial loss arising from fluctuations in market interest rates. Unlike specific risk, which focuses on the creditworthiness of individual issuers, this charge addresses broad market movements. It ensures that banks maintain sufficient capital to absorb losses resulting from adverse changes in the general yield curve.

11. (C) Both (I) and (II)
The Basel Committee provides two frameworks for measuring market risk capital, which are the standardised method and internal models. In India, banks are currently required to follow the standardised duration method for their regulatory reporting. This approach provides a consistent and structured way to calculate capital requirements while the capabilities for advanced internal modeling are being developed locally.

12. (C) Because banks face risks from intra-day movements of market indices to which they are exposed.
Market indices and price variables can experience significant volatility during a single business day. Banks are exposed to these intra-day price movements, which can impact the value of their trading positions before the close of business. Maintaining strict risk management systems ensures that these exposures are monitored and controlled, preventing potential losses from exceeding the bank's risk appetite.

13. (B) (II) and (IV) only
Capital charges for investments in bank-issued instruments are tiered based on the issuer's capital adequacy. A fifty-six point twenty-five percent charge applies when the issuing bank's Common Equity Tier 1 plus Capital Conservation Buffer falls below fifty percent of the requirement. This same high charge is also mandated if the issuer's Common Equity Tier 1 is below the minimum.

14. (A) 0.00%
Foreign sovereign exposures attract specific risk capital charges based on their international credit ratings. Central governments and central banks with high ratings in the AAA to AA range are considered to have minimal default risk. Consequently, the regulatory framework sets the specific risk capital charge for these highly-rated foreign government securities at zero percent within the trading book.

15. (D) To capture the risk of value loss due to adverse market index changes affecting the investment portfolio.
The primary objective of the general market risk capital requirement is to protect the bank's portfolio from losses caused by broad market fluctuations. It specifically addresses interest rate risk and the impact of changes in market indices. By holding this capital, banks create a buffer against value declines in their investment positions resulting from adverse movements in macroeconomic variables.

16. (C) From the end of 1997
Following international regulatory developments, the requirement for banks to maintain capital for market risk was phased in alongside credit risk. In the Indian context, banks were mandated to start measuring and applying specific capital charges for their market risk exposures from the end of 1997. This marked a significant step in aligning domestic banking regulations with Basel standards.

17. (B) P-3, Q-4, R-1, S-2
The alternative total capital charge for Available for Sale corporate bonds depends on their credit rating. Bonds rated AAA are subject to a one point eight percent charge. Those rated AA require a two point seven percent charge. Securities with an A rating attract a four point five percent charge, while BBB rated bonds are charged nine percent of value.

NODIA

54. (B) Risk-weighted at 100%; Capital charge is 9%
Foreign exchange and gold open positions are treated as high-risk exposures. The regulatory framework requires these positions to be risk-weighted at one hundred percent. Based on a minimum capital adequacy ratio of nine percent, the resulting capital charge for these market risk exposures is nine percent. This ensures that banks maintain a robust buffer against fluctuations in currency and gold prices.

55. (A) That interest rate movements within each of the specific time bands are perfectly correlated with one another.
When the regulatory framework allows for full offsetting of long and short positions within a time band, it relies on a specific mathematical assumption. It assumes that interest rate movements for all instruments in that band are perfectly correlated. Since this is rarely the case in reality, the vertical disallowance charge is applied to the matched positions to account for any discrepancies.

56. (C) Zone 3 : 30%
Within-zone disallowance factors vary across the maturity ladder to account for differing volatilities and correlations. For Zone 1, which contains short-term maturities, the factor is forty percent. For Zone 2, it is thirty percent. Zone 3, which encompasses long-term maturities, also has a thirty percent disallowance factor. These factors ensure that capital is held against basis risk within each zone.

57. (C) Both (I) and (II)
Banks must maintain capital for foreign exchange risk at a rate of nine percent of their open positions, using the higher of the actual position or the approved limit. This market risk capital charge is a distinct requirement and is maintained in addition to any capital held for credit risk on the underlying on-balance and off-balance sheet foreign exchange transactions.

58. (A) ₹54.00 crores
To calculate the across-zone disallowance, the bank identifies the matched portion between the residual positions of two zones. Here, the matched amount between the Zone 1 long position and the Zone 2 short position is one hundred thirty-five crores. Applying the forty percent disallowance factor for these adjacent zones to the matched amount results in a fifty-four crore capital charge.

59. (C) It includes non-convertible preference shares held within the trading book.
Equity risk capital requirements apply to instruments that behave like equities, such as common stocks and convertible securities. They cover both voting and non-voting shares and firm commitments in the future. However, non-convertible preference shares are treated as debt instruments for capital purposes. Therefore, they are not included in the calculation for equity risk capital charges in the trading book.

60. (C) Disallowance across zones 3 and 4.
The standardised duration method uses a three-zone structure to categorize maturities. Consequently, the sequence for horizontal disallowance involves adjustments between Zone 1 and Zone 2, followed by Zone 2 and Zone 3, and finally between Zone 1 and Zone 3. Since there is no fourth zone in this framework, adjustments involving a Zone 4 are not part of the standard regulatory sequence.

61. (A) (I) and (II) only
The netting process for general market risk involves aggregating interest rate exposures, which may be positive or negative. Long and short positions are offset against each other, but this netting is subject to specific disallowance provisions to ensure capital is held for basis and yield curve risks. Offsetting across different currencies is generally restricted and requires separate calculations for each currency.

62. (A) General Market Risk capital charge is expected to protect the bank against interest rate risk.
The general market risk capital charge is specifically designed to protect a bank against losses resulting from changes in market interest rates. While specific risk focuses on issuer-related factors, the general charge addresses the impact of yield curve shifts on the trading portfolio. This ensures that the bank remains resilient to broad fluctuations in the interest rate environment across its holdings.

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27. (A) (I), (II), and (IV) only
The final capital requirement for Available for Sale securities involves calculating an alternative total capital charge based on banking book rules. Additionally, banks must compute a notional charge consisting of Held for Trading specific risk and general market risk. The regulatory requirement is to maintain capital equal to the greater of these two computed values to ensure adequate risk coverage.

28. (A) Only (I)
Short positions are generally restricted for banks in India, with exceptions only for derivatives and Central Government securities. This limitation influences how market risk is calculated and reported. Regarding Available for Sale debt securities, the regulatory framework requires banks to hold a capital charge that is the greater of two distinct calculation methods, rather than the lesser of them.

29. (A) (I), (IV), (III), (II)
To estimate the specific risk capital charge for the trading portfolio, a bank first segregates instruments held in the Held for Trading category. It then computes the residual period to maturity for each instrument. Next, the bank identifies the relevant regulatory factor from prescribed tables. Finally, it calculates the charge by applying the specific factor to the instrument's value.

30. (D) Investments in other approved securities guaranteed by Central Government : 0.00%
Investments in Central Government securities and those guaranteed by the Central Government are exempt from specific risk capital charges. These exposures carry a zero percent charge regardless of their maturity. However, securities guaranteed by State Governments are subject to specific risk charges ranging from zero point twenty-eight percent to one point eight percent depending on the time remaining until they mature.

31. (C) Assertion (A) is true, but Reason (R) is false.
Vertical disallowance is calculated as five percent of the matched long and short positions within a single time band. This charge is intended to cover basis risk, which is the risk that price relationships between similar instruments fluctuate. It is not designed to address yield curve risk, which involves interest rate movements across different maturity zones or time horizons.

32. (B) Specific Risk: ₹78.75 crores; General Market Risk: ₹63.00 crores
For equity shares held in the trading book, the specific risk capital charge is eleven point twenty-five percent of the gross position. For a seven hundred crore portfolio, this equals seventy-eight point seventy-five crores. The general market risk charge for equities is set at nine percent of the gross position. For this same portfolio, the general market risk charge is sixty-three crores.

33. (B) (III), (I), (IV), (II)
Under the duration method, a bank first calculates the marked to market value and residual maturity of its securities. These are then slotted into one of fifteen prescribed time bands. Next, the bank computes interest rate sensitivity by multiplying modified duration by the assumed change in yield. Finally, this sensitivity is applied to the market value of each security.

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34. (D) Outstanding principal of all domestic retail loans denominated in local currency.
Calculating the net open position in a foreign currency involves summing the net spot position and the net forward position. It also includes guarantees certain to be called and hedged future income not yet accrued. However, domestic retail loans denominated in the local currency are not part of the foreign exchange risk calculation as they do not involve currency fluctuations.

35. (A) (I), (II), (III), and (V)
Horizontal disallowance accounts for yield curve risk due to imperfect correlation of interest rates across different maturities. Residual positions from time bands are carried forward for offsetting between zones. The framework assumes that the farther apart the time bands are, the lower the correlation, resulting in higher capital add-ons. It addresses the limitation of assuming a perfectly constant yield curve shift.

CHAPTER 27
Capital Charge for Operational Risk

Oct/Nov 2023

1. What is the Business Indicator (BI) Marginal Co-efficient (α_i) for Bucket 2 (where 8,000 $\leq$ BI $<$ 2,40,000 in monetary units)?
(A) 10%
(B) 12%
(C) 15%
(D) 18%

May/June 2007

2. Which statement regarding the items included in the gross loss computation of the loss data set is incorrect?
(A) Direct charges, including impairments and settlements, to the bank's P&L accounts are included.
(B) Provisions or reserves accounted for in the P&L against the potential operational loss impact are included.
(C) Costs of general maintenance contracts on property, plant or equipment are included.
(D) Material pending losses temporarily booked in suspense accounts are included.

Oct/Nov 2014

3. What is the definition of the Internal Loss Multiplier (ILM)?
(A) A fixed percentage relating the level of required capital to the gross income of eight business lines.
(B) A regulatory determined constant based on the size of the bank.
(C) A scaling factor that is based on a bank's average historical losses and the Business Indicator Component (BIC).
(D) A proxy repres 1 −enting the industry-wide relationship between operational risk loss experience and aggregate gross income.

May/June 2021

4. What is the most appropriate reason for requiring an absolute value function, Abs(Interest Income - Interest Expenses), when computing the Interest, Lease and Dividend Component (ILDC)?
(A) To penalize banks that have a net interest expense rather than net interest income during a financial year.
(B) To align the calculation with advanced internal measurement criteria used by top-tier international banking institutions.
(C) To ensure the margin between interest income and expenses contributes to the operational risk proxy regardless of being net income or expense.
(D) To offset negative capital charges in other business lines automatically without requiring manual regulatory adjustment.

Oct/Nov 2009

5. How must operational loss events that relate to credit risk, but are not accounted for in credit Risk-Weighted Assets (RWA), be treated?
(A) They must be excluded from the operational loss data set to avoid double counting.
(B) They shall be included in the operational loss data set.
(C) They should be allocated to market risk RWA instead.
(D) They are excluded unless they exceed a specific established materiality threshold.

May/June 2018

6. What is the most accurate reflection of how the Business Indicator Component (BIC) scales as a bank's Business Indicator (BI) increases?
(A) The BIC scales uniformly at 15% across all BI amounts.
(B) The BIC scales using progressively higher marginal coefficients as the BI crosses specific bucket thresholds.
(C) The BIC scales inversely with the size of the bank to protect smaller institutions.
(D) The BIC scales proportionally based on the Internal Loss Multiplier (ILM) alone.

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category.
III Include reversal during the year in respect of provisions made during previous years.
IV Exclude income from legal settlements in favour of the bank.
V Be net of operating expenses, including fees paid to outsourcing service providers.
Which of the above statement(s) correctly identifies the rules for gross income measurement?
(A) (I), (II), and (IV)
(B) (I), (III), and (V)
(C) (II), (IV), and (V)
(D) (I), (II), (IV), and (V)

Oct/Nov 2008

33. Match the typical sub-items in List I to their respective financial statement items in List II:
List I: (Financial Sub-items)
P. Interest income from hedge accounting derivatives
Q. Total gross outstanding loans and advances
R. Dividend income from non-consolidated subsidiaries
S. Gains from non-current assets classified as held for sale
List II: (Indicator Items)
1. Dividend income
2. Other operating income
3. Interest earning assets
4. Interest income
(A) P-2, Q-3, R-1, S-4
(B) P-4, Q-3, R-1, S-2
(C) P-4, Q-1, R-3, S-2
(D) P-3, Q-4, R-2, S-1

May/June 2006

34. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option to describe the relationship between them.
Assertion (A): While building an operational loss data set, anticipated receivables from an insurance company can be used immediately to report net loss in the dataset.
Reason (R): A recovery is an independent occurrence related to the original loss event, and verifiable payments must be received before they can reduce reported losses.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

NODIA

Oct/Nov 2017

35. Consider the following statements regarding the exclusion of losses from an operational loss data set:
I The excluded loss event must be strictly greater than 10% of the bank's average losses.
II Losses can be excluded immediately upon discovery without any minimum retention period in the operational risk loss database.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2008

36. Based on the figures provided in the scenario for Question 57, what is the calculated operational risk capital requirement (K_{BIA}) for the bank?
(A) 48.75 units
(B) 30 units
(C) 97.5 units
(D) 32.5 units

Oct/Nov 2013

37. Match the concepts related to capital calculation in List I with their corresponding mathematical expressions or values in List II:
List I: (Capital Calculation Concepts)
P. Loss Component (LC)
Q. Risk Weighted Assets (RWA)
R. Internal Loss Multiplier (ILM)
S. Minimum threshold for loss event
List II: (Expressions or Values)
1. $\ln [e^1 - 1 + (LC / BIC)^{0.8}]$
2. 15 × average annual operational risk losses
3. ORC × 12.5
4. Rs 1,00,000
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3

Oct/Nov 2018

13. Which of the following statements regarding the business lines in the Standardized Approach (TSA) is incorrect?

(A) Payment and settlement is assigned a beta factor of 15%.

(B) Corporate finance is assigned a beta factor of 18%.

(C) Retail banking is assigned a beta factor of 12%.

(D) Agency services is assigned a beta factor of 15%.

May/June 2016

14. Which of the following statements correctly describes the calculation rule for annual gross income under the Basic Indicator Approach (BIA)?

(A) Years with negative or zero gross income are assigned a default value of 1% and included in the denominator for averaging.

(B) Negative gross income is included in the denominator to reduce the overall capital requirement in line with profitability.

(C) Figures for any year in which annual gross income is negative or zero are excluded from both the numerator and denominator.

(D) Negative gross income offsets positive gross income from previous years before applying the alpha factor to the final average.

Oct/Nov 2025

15. When evaluating the relevance of operational loss events to a bank's risk profile for the purpose of loss exclusion, what does a regulatory authority primarily expect the bank to demonstrate?

(A) That the total loss amount does not exceed the Business Indicator threshold for the current reporting cycle.

(B) That the cause of the loss event could theoretically occur in other areas of the bank's global operations.

(C) That the loss has been fully recovered through various insurance payouts or legal counter-claims.

(D) That no similar or residual legal exposure remains and the excluded loss has no relevance to other continuing activities or products.

May/June 2023

16. Under the standardized approach for calculating operational risk, what is the definition of the Business Indicator (BI)?

(A) A financial-statement-based proxy for operational risk consisting of three elements calculated as the average over three years.

(B) A proxy for operational risk based on the internal risk measurement system of the bank and its specific historical loss distribution.

(C) A scaling factor that is based on a bank's average historical losses and marginal coefficients determined by the national regulator.

(D) An indicator reflecting the scale of business operations based exclusively on net interest income and dividend yields from subsidiaries.

Oct/Nov 2016

17. All of the following items are excluded from the gross loss computation of the operational loss data set, EXCEPT:

(A) Costs of repair or replacement incurred to restore the position that was prevailing before the operational risk event occurred.

(B) Internal expenditures to enhance the business infrastructure after the realization of operational risk losses.

(C) Insurance premiums paid to third-party providers for the mitigation of operational or physical risks.

(D) External expenditures for specific risk assessment initiatives and general control enhancements following an event.

May/June 2014

18. What is the multiplier used to calculate the risk-weighted assets (RWA) for operational risk from the Operational Risk Capital (ORC)?

(A) 8.0

(B) 10.0

(C) 12.5

(D) 15.0

Oct/Nov 2007

19. Which of the following statements about exclusions of operational losses from a data set is incorrect?

(A) Banks may request the regulatory

NODIA

Oct/Nov 2018

55. Consider the following statements regarding operational risk loss data collection:

I The minimum threshold for including a loss event in the data set is often set at Rs 1,00,000.

II A bank's internal loss data must capture all material activities and exposures from all appropriate subsystems.

III The date when a loss event results in a reserve being recognized is exclusively referred to as the "date of discovery".

IV The financial impacts of events paid by the outsourcer are not considered operational losses of the bank.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

May/June 2016

56. Match the Business Line in List I with its corresponding Beta Factor (β) in List II under the Standardized Approach (TSA):

List I: (Business Line)
P. Corporate finance
Q. Agency services
R. Retail banking
S. Unassigned / None of the above

List II: (Beta Factor)
1. 12%
2. 15%
3. 18%
4. 10%

(A) P-3, Q-2, R-1, S-4
(B) P-2, Q-3, R-4, S-1
(C) P-1, Q-4, R-2, S-3
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2025

57. A bank is computing its operational risk capital under the Basic Indicator Approach (BIA). Over the previous three years, its annual gross income figures were as follows:

Year 1: 400 units
Year 2: -50 units
Year 3: 250 units

The fixed percentage (α) is 15%. What is the value of the denominator (n) that should be used to calculate the average gross income for this bank?

(A) 1
(B) 2
(C) 3
(D) 0

May/June 2023

58. Consider the following statements regarding the Basic Indicator Approach (BIA):

I The capital requirement under BIA is equal to the average of the previous three years of a fixed percentage (α) of positive annual gross income.

II Years in which annual gross income is negative or zero are included in the denominator to calculate the average.

Which of the above statement(s) is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2016

59. Concerning the specific criteria on operational loss data identification and treatment:

I Gross loss is defined as a loss before recoveries of any type.

II Receivables count as recoveries and can immediately reduce losses in the dataset.

III Losses stemming from operational risk events temporarily booked in suspense accounts are strictly excluded until finalized.

IV Loss impacts denominated in a foreign currency must be converted using the exchange rate of the period the loss impacts are accounted for.

V Operational risk losses related to market risk are included in the operational loss data set.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III)
(B) (I), (IV), and (V)
(C) (II), (IV), and (V)
(D) (I), (III), and (IV)

May/June 2014

60. Consider the following statements about building an operational loss data set:

I Operational risk losses related to market

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May/June 2017

26. How is "Net loss" defined in the context of building an operational loss data set?

(A) A loss before taking into account the impact of recoveries of any type or insurance payouts.

(B) The loss after taking into account the impact of recoveries, where receivables are immediately counted as recoveries by the bank.

(C) The absolute value of sub-components irrespective of their signs in the financial statements or accounting ledger.

(D) The loss after accounting for recoveries, where recoveries reduce losses only after the bank receives the actual payment.

Oct/Nov 2005

27. Which of the following best describes "date of accounting" in the context of building a loss data set for legal loss events?

(A) The date when a legal reserve is established for the probable estimated loss in the bank's Profit and Loss financial statement.

(B) The date when the bank first became aware of the existence of the event or potential liability.

(C) The date when the event originally occurred or the date of the first related transaction.

(D) The date when the final settlement is paid to the third party after all appeals are exhausted.

May/June 2020

28. Which fundamental weakness of previous approaches primarily motivated the formulation of the New Standardized Approach for operational risk?

(A) Legacy approaches used Gross Income as a proxy, leading to lower capital requirements when income declines due to operational events.

(B) Existing approaches relied too heavily on internal loss data which was unavailable for small banks or newly established institutions.

(C) Existing approaches required complex calculations involving the Internal Loss Multiplier (ILM) which made cross-bank comparisons difficult.

(D) Existing approaches divided banking activities into too few business lines, lacking the operational granularity needed for modern risks.

NODIA

Oct/Nov 2015

29. The definition of operational risk encompasses all of the following EXCEPT:

(A) Risk of loss from inadequate or failed internal processes

(B) Risk of loss from external events

(C) Reputational risk

(D) Legal risk

May/June 2013

30. Which statement accurately reflects the calculation of Operational Risk Capital (ORC) for banks categorized in Bucket 1?

(A) ORC requirement shall be equal to the Business Indicator Component (BIC) multiplied by the Internal Loss Multiplier (ILM).

(B) ORC is calculated as the simple average of BIC over the previous three years.

(C) ORC equals 15 times the average annual operational risk losses.

(D) ORC requirement shall be equal to the Business Indicator Component (BIC).

Oct/Nov 2021

31. Which of the following is correctly paired regarding the gross loss computation for operational risk?

(A) Excluded from gross loss — Negative economic impacts booked in a financial accounting period ("timing losses")

(B) Excluded from gross loss — Direct charges, including impairments and settlements

(C) Included in gross loss — Provisions or reserves accounted for in the Profit and Loss against potential operational loss impact

(D) Included in gross loss — Insurance premiums

May/June 2024

32. Under the gross income definition for the Basic Indicator Approach (BIA), it is intended that this measure should:

I Be gross of any provisions (e.g. for unpaid interest).

II Exclude realised profits/losses from the sale of securities in the "held to maturity"

Oct/Nov 2022

7. In the context of a capital adequacy framework, how is operational risk explicitly defined?
(A) The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including strategic and reputational risk as well as business risk.
(B) The risk of loss resulting from failed internal processes, people and systems or from external events, including legal risk but excluding strategic and reputational risk.
(C) The risk of loss resulting from specific supervisory actions and private settlements, strictly excluding internal process failures or technology-based system errors.
(D) The risk of loss resulting exclusively from external events and legal risk, including strategic risk and losses arising from standard business cycle fluctuations.

May/June 2012

8. Regarding the calculation of the Business Indicator (BI) macro-components, which of the following is correct?
(A) The Interest, Lease and Dividend Component (ILDC) includes the absolute value of the Net P&L Trading Book items.
(B) The absolute value of net items is calculated annually first, then the three-year average of those absolute values is taken.
(C) A bar above a term in the BI formula indicates that it is calculated as the average over five years for stability.
(D) Fee Income and Fee Expense are added to calculate the Financial Component (FC) as per the revised standardized framework.

Oct/Nov 2010

9. The Business Indicator (BI) is computed as the summation of three macro-components. Which of the following is NOT one of these components?
(A) Interest, Lease and Dividend Component (ILDC)
(B) Internal Loss Component (ILC)
(C) Services Component (SC)
(D) Financial Component (FC)

May/June 2019

10. Under the Standardized Approach (TSA), how are negative capital charges in any business line for a given year treated when calculating the total capital charge?
(A) They are ignored and replaced with zero for that specific business line and reporting period.
(B) They offset positive capital charges up to a limit of 15% of total gross income for that specific year.
(C) They may offset positive charges in other business lines without limit, but if the aggregate is negative, the year's input is zero.
(D) They are converted to their absolute value and added to the aggregate capital charge to ensure conservatism.

Oct/Nov 2006

11. Arrange the following steps sequentially as required to calculate the final Risk Weighted Assets (RWA) for operational risk under the standardized approach for a bank with ten years of loss data:
I. Calculate Operational Risk Capital (ORC) by multiplying BIC and ILM
II. Calculate the Business Indicator (BI) using financial statement components
III. Multiply ORC by 12.5 to arrive at RWA
IV. Compute the Business Indicator Component (BIC) using marginal coefficients
V. Compute the Internal Loss Multiplier (ILM) using the Loss Component (LC) and BIC
(A) II, V, IV, I, III
(B) IV, II, I, V, III
(C) V, II, IV, III, I
(D) II, IV, V, I, III

May/June 2005

12. Under the Basic Indicator Approach for operational risk, what is the fixed percentage (α) typically set by regulatory standards?
(A) 12%
(B) 15%
(C) 18%
(D) 20%

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(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

May/June 2015

38. Which of the following were identified as weaknesses of older methodological approaches (such as BIA, TSA, AMA) prior to the implementation of the New Standardized Approach?

I Capital requirements remained unchanged or fell despite an increase in the number and severity of operational events.
II The assumption that a bank's operational risk exposure increases linearly with income proved flawed.
III Existing simpler approaches were overly sensitive to internal loss models, penalizing smaller banks.
IV Complex and different methods adopted by banks made them incomparable at the regulatory level.

Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

Oct/Nov 2012

39. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option to describe the relationship between them.

Assertion (A): Legal risk is included in the definition of operational risk under standardized regulatory guidelines.

Reason (R): Legal risk includes exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2011

40. Identify the incorrectly paired Beta factor for the Standardized Approach (TSA) business lines:
(A) Payment and settlement — 18%
(B) Trading and sales — 18%
(C) Asset management — 12%
(D) Commercial banking — 12%

Oct/Nov 2020

41. Based on the Standardized Approach (TSA) scenario in Question 51, what is the capital charge specific to the Commercial banking business line?
(A) -24 units
(B) -30 units
(C) 0 units
(D) -36 units

May/June 2022

42. Match the terms in List I with their contextual application in List II:

List I: (Regulatory Terms)
P. Alpha (α)
Q. Beta (β)
R. Marginal coefficient (α_i)
S. 12.5

List II: (Application)
1. Multiplier to calculate RWA from ORC
2. Fixed percentage used under the Basic Indicator Approach
3. Factor that scales the BIC progressively across BI buckets
4. Proxy for industry-wide risk relationship for a specific business line in TSA

(A) P-4, Q-2, R-1, S-3
(B) P-3, Q-1, R-4, S-2
(C) P-2, Q-4, R-3, S-1
(D) P-2, Q-3, R-1, S-4

Oct/Nov 2023

43. Consider the following items evaluated for inclusion in or exclusion from the gross loss computation:

I Costs incurred to restore the position prevailing before the event.
II Internal expenditures to enhance the business after the operational risk losses.
III Negative economic impacts booked due to operational risk events ("timing losses").
IV Insurance premiums.

Which of the above items are EXCLUDED

NODIA

authority to exclude certain operational loss events that are no longer relevant to their risk profiles.
(B) Exclusion of losses shall be subject to a materiality threshold, for example, where the excluded loss event is greater than 5% of the bank's average losses.
(C) Losses can only be excluded after being included in the bank's operational risk loss database for a minimum period (e.g., three years).
(D) Losses related to divested activities are strictly subjected to the minimum operational risk loss database retention period of three years.

May/June 2025

20. Identify the correct statement regarding the Internal Loss Multiplier (ILM) scaling framework.
(A) The Loss Component (LC) is equal to 15 times the average annual operational risk losses.
(B) The calculation of average losses in the LC is strictly based on a fixed 5-year historical data set.
(C) The minimum threshold for including a loss event in the dataset is Rs 50,000.
(D) The ILM applies uniformly to all banks regardless of their BI bucket and availability of loss data.

Oct/Nov 2019

21. Arrange the following methodological frameworks for calculating operational risk capital charges in the continuum of increasing sophistication and risk sensitivity:
I. Advanced Measurement Approaches (AMA)
II. Basic Indicator Approach (BIA)
III. The Standardised Approach (TSA)
(A) II, I, III
(B) III, II, I
(C) II, III, I
(D) I, III, II

May/June 2009

22. In the Standardized Approach (TSA), banks' activities are divided into how many business lines?
(A) Three
(B) Five
(C) Eight
(D) Ten

Oct/Nov 2011

23. Under the Standardized Approach (TSA), what does the factor Beta (β) represent?
(A) The bank's internal operational risk measurement scaling factor used to adjust for specific control environment weaknesses.
(B) The minimum threshold for including a loss event in the internal data set based on the bank's materiality policy.
(C) The margin by which operational risk capital must exceed market risk capital to ensure a robust overall buffer.
(D) A proxy for the industry relationship between a business line's loss experience and its aggregate gross income.

May/June 2010

24. Which of the following Profit and Loss (P&L) items contributes to the components of the Business Indicator (BI)?
(A) Income and expenses from insurance or reinsurance businesses
(B) Recovery of administrative expenses including taxes debited to customers
(C) Changes in goodwill recognised in profit or loss
(D) Interest income from financial and operating leases

Oct/Nov 2024

25. Identify the incorrect statement regarding the items excluded from the definition of Gross Income under the Basic Indicator Approach.
(A) Reversal during the year in respect of provisions and write-offs made during the previous year(s) are excluded.
(B) Income derived from insurance activities and insurance claims in favour of the bank is included.
(C) Realised profits/losses from the sale of securities in the "held to maturity" category are excluded.
(D) Income recognised from the disposal of items of movable and immovable property is excluded.

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III Impairment/reversal of impairment on financial assets.
IV Recovery of administrative expenses on behalf of customers.
V Income received from providing advice and services.

Which of the above statements correctly identify items that DO NOT contribute to any of the items of the BI?
(A) (I), (III), and (IV)
(B) (II), (IV), and (V)
(C) (I), (II), and (V)
(D) (III), (IV), and (V)

May/June 2012

50. Consider the following items with respect to the Business Indicator (BI):
I Income and expenses from insurance businesses.
II Depreciation related to operating lease assets.
III Administrative expenses including staff expenses.

Which of the above items DO NOT contribute to any of the items of the BI?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2010

51. A commercial bank uses the Standardized Approach (TSA) to calculate operational risk capital. In a given year, it reports the following gross income figures for three of its business lines:
Retail banking: 1,000 units
Commercial banking: -200 units
Corporate finance: 500 units
Assume these are the only business lines operated by the bank. What is the regulatory capital charge specific to the Retail banking business line for this year before aggregation?
(A) 150 units
(B) 180 units
(C) 100 units
(D) 120 units

May/June 2019

52. Identify the correct pair of Business Indicator (BI) Component and its typical sub-item:
(A) Financial Component — Income from ordinary banking operations not included in other BI items
(B) Interest, lease and dividend Component — Fees paid to advisors, attorneys or suppliers
(C) Services Component — Depreciation and impairment of operating leased assets
(D) Services Component — Clearing and settlement fee income

Oct/Nov 2006

53. Consider the following statements regarding the Operational Risk Capital (ORC):
I For banks in Bucket 1, the ORC requirement is equal to the Business Indicator Component (BIC).
II For banks in Bucket 2 and 3 having 5 years and above of high-quality data, ORC is calculated by multiplying BIC by the Internal Loss Multiplier (ILM).

Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2005

54. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option to describe the relationship between them.
Assertion (A): Under the Basic Indicator Approach (BIA), figures for any year in which annual gross income is negative or zero are excluded from both the numerator and the denominator.
Reason (R): Including negative gross income would reduce the average gross income, thereby artificially lowering the capital charge required to cover operational risk.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

NODIA

from the gross loss computation?
(A) (I) and (II)
(B) (II) and (III)
(C) (III) and (IV)
(D) (II) and (IV)

May/June 2007

44. Consider the following statements regarding the Standardized Approach (TSA) calculation:
I Within each business line, gross income serves as a proxy for the scale of business operations.
II Negative capital charges in any business line may offset positive capital charges in other business lines without limit in a given year.
III The total capital charge is calculated as the simple summation of the regulatory capital charges across each business line calculated for a single year.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2014

45. Based on the figures provided in the scenario for Question 57, what is the average gross income to be considered for calculating the capital requirement?
(A) 200 units
(B) 650 units
(C) 325 units
(D) 216.67 units

May/June 2021

46. Match the Business Indicator (BI) components in List I with their respective formulas in List II:
List I: (BI Components)
P. ILDC
Q. SC
R. FC
S. BI
List II: (Formulas)
1. ILDC + SC + FC
2. Abs(Net P&L Trading Book) + Abs(Net P&L Banking Book)
3. Min[Abs(Interest Income - Interest Expenses); 2.25% × Interest Earning Assets] + Dividend Income
4. Max[Other Op. Income; Other Op. Expense] + Max[Fee Income; Fee Expense]
(A) P-4, Q-3, R-1, S-2
(B) P-3, Q-4, R-2, S-1
(C) P-3, Q-2, R-4, S-1
(D) P-2, Q-1, R-3, S-4

Oct/Nov 2009

47. The following question consists of two statements, an Assertion (A) and a Reason (R). Choose the correct option to describe the relationship between them.
Assertion (A): Regulatory frameworks have moved toward replacing Gross Income (GI) with the Business Indicator (BI) in standardized approaches.
Reason (R): The use of GI assumed that operational risk exposure increases linearly with income, leading to a decrease in capital requirements when operational risk events cause income to decline.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2018

48. Which of the following financial items is incorrectly paired with its indicative accounting schedule (assuming a standard banking reporting format)?
(A) Interest income — Schedule 13
(B) Fee and commission expenses — Schedule 14 (I)
(C) Interest expenses — Schedule 15
(D) Other operating income — Schedule 14 (IV)

Oct/Nov 2022

49. Consider the following statements regarding Profit and Loss (P&L) items and their contribution to the Business Indicator (BI):
I Corporate income tax.
II Dividend income from investments in stocks not consolidated.

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risk shall be included in the operational loss data set.

II Operational loss events that relate to credit risk and that are accounted for in credit Risk-Weighted Assets (RWA) shall be included in the operational loss data set.

III For operational losses from outsourced activities, financial impacts paid by the outsourcer are not included as operational losses of the bank.

Which of the above statement(s) is/are correct?

(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

Oct/Nov 2007

61. If the bank in Question 65 had only 4 years of high-quality operational risk annual loss data, what would be its ORC requirement?

(A) 17,250 units
(B) 12,500 units
(C) 15,000 units
(D) Zero, until it collects 5 years of data.

May/June 2025

62. Referring to the bank in Question 66, which of the following formulas represents the correct calculation of the BIC?

(A) BIC = (8,000 × 12%) + (2,32,000 × 15%) + (60,000 × 18%)
(B) BIC = (3,00,000 × 18%)
(C) BIC = (8,000 × 15%) + (2,32,000 × 12%) + (60,000 × 18%)
(D) BIC = (8,000 × 12%) + (2,40,000 × 15%) + (60,000 × 18%)

Oct/Nov 2019

63. Based on the Standardized Approach (TSA) scenario in Question 51, what is the aggregate capital charge across these three business lines for the given year?

(A) 150 units
(B) 210 units
(C) 180 units
(D) 120 units

May/June 2009

64. Based on the Bank Zenith scenario in Question 67, what amount should the bank report as the "net loss" in its current operational risk dataset before the insurance payment is received?

(A) 7 units
(B) 13 units
(C) 10 units
(D) 8 units

Oct/Nov 2011

65. A bank operating in Bucket 2 has computed its Business Indicator Component (BIC) as 15,000 units. The bank possesses a high-quality operational risk historical loss data set spanning 8 years. The bank determines its Internal Loss Multiplier (ILM) to be 1.15. Under the standardized approach, how should the bank determine its Operational Risk Capital (ORC) given its loss data availability?

(A) Since the bank has less than 10 years of data, ORC is strictly equal to the BIC regardless of loss history.
(B) Since the bank has five years or more of high-quality data, ORC is calculated by multiplying the BIC by the ILM.
(C) The bank must use an advanced internal measurement approach instead of the standardized framework for its calculations.
(D) The bank must extrapolate its 8-year data to a full 10-year period before it can accurately calculate the ILM factor.

May/June 2010

66. A large bank has computed its Business Indicator (BI) to be 3,00,000 units based on its financial statements over the last three years. The bank must compute its Business Indicator Component (BIC) according to prescribed marginal coefficients. Under which BI Bucket does the bank's BI fall?

(A) Bucket 1
(B) Bucket 2
(C) Bucket 3
(D) Bucket 4

Oct/Nov 2024

67. Bank Zenith faces an operational risk event resulting from an internal fraud. The event causes direct legal settlements to third parties of 10 units, internal expenses to upgrade security systems of 2 units, and general maintenance of affected premises of 1 unit. An

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8. (B) The absolute value of net items is calculated annually first, then the three-year average of those absolute values is taken.
To compute the business indicator components, banks must first determine the absolute values of specific net items for each financial year. Once these annual values are established, the regulatory framework requires taking a three-year average of these amounts. This method ensures that the final indicator reflects recent historical business volume while smoothing out annual fluctuations in financial statements.

9. (B) Internal Loss Component (ILC)
The business indicator is derived from three primary macro-components: the interest, lease and dividend component, the services component, and the financial component. These elements are calculated from financial statement data to serve as a proxy for operational risk exposure. In contrast, the internal loss component is a separate metric used to determine the internal loss multiplier.

10. (C) They may offset positive charges in other business lines without limit, but if the aggregate is negative, the year's input is zero.
Under the standardized approach, regulatory guidelines allow banks to offset negative capital charges in one business line against positive charges in others during a single year without specific limits. However, if the aggregate calculation for all business lines results in a negative value for that specific year, the input for that reporting period is treated as zero.

11. (D) II, IV, V, I, III
Calculating operational risk-weighted assets involves a sequential process beginning with determining the business indicator from financial data. This is used to compute the business indicator component using marginal coefficients. Subsequently, the internal loss multiplier is derived from historical losses, allowing for the calculation of the operational risk capital. Finally, this capital requirement is multiplied by a fixed factor.

12. (B) 15%
The basic indicator approach represents the simplest method for determining operational risk capital. It utilizes a single fixed percentage, known as the alpha factor, which is applied to the average positive annual gross income of the bank over the previous three years. According to established regulatory standards, this factor is consistently set at fifteen percent for all participating institutions.

13. (A) Payment and settlement is assigned a beta factor of 15%.
In the standardized approach, business lines are assigned specific beta factors representing their relative operational risk intensity. While retail banking and asset management carry a factor of twelve percent, and commercial banking or agency services carry fifteen percent, payment and settlement activities are categorized with the highest risk factor of eighteen percent, alongside corporate finance and trading operations.

14. (C) Figures for any year in which annual gross income is negative or zero are excluded from both the numerator and denominator.
When calculating average gross income under the basic indicator approach, regulatory rules specify that only years with positive income are considered. Any financial year where the gross income is zero or negative must be entirely excluded from the calculation. This exclusion applies to both the numerator of the average and the denominator representing the total years counted.

15. (D) That no similar or residual legal exposure remains and the excluded loss has no relevance to other continuing activities or products.
To exclude a historical operational loss event from the dataset, a bank must provide robust evidence to the regulator. It must be clearly demonstrated that the event has no remaining relevance to the bank's current risk profile. This involves showing that no residual legal exposure exists and that the circumstances leading to the loss cannot recur.

16. (A) A financial-statement-based proxy for operational risk consisting of three elements calculated as the average over three years.
The business indicator serves as a standardized financial proxy designed to measure the scale of a bank's exposure to operational risk. It is computed as the sum of three distinct

NODIA

ANSWERS

1. (C) 15%
Under the standardized framework for operational risk, the business indicator component utilizes progressive marginal coefficients based on defined buckets of business volume. For the second bucket, which covers business indicator values ranging from eight thousand to two hundred and forty thousand monetary units, the specific marginal rate applied to this segment of the indicator is set at fifteen percent.

2. (C) Costs of general maintenance contracts on property, plant or equipment are included.
Gross loss computation for operational risk datasets specifically focuses on direct financial impacts arising from specific risk events. While direct charges, provisions for potential impacts, and material pending losses in suspense accounts are mandatory inclusions, standard operational expenditures such as general maintenance contracts for property or equipment are excluded as they represent regular business costs rather than risk losses.

3. (C) A scaling factor that is based on a bank's average historical losses and the Business Indicator Component (BIC).
The internal loss multiplier serves as a risk-sensitive scaling factor designed to adjust the capital requirement based on a bank's actual internal loss experience. It incorporates the relationship between average historical operational losses, represented by the loss component, and the business indicator component, ensuring that institutions with higher loss frequencies or severities maintain appropriate regulatory capital buffers.

4. (C) To ensure the margin between interest income and expenses contributes to the operational risk proxy regardless of being net income or expense.
The inclusion of an absolute value function when calculating the margin between interest income and interest expenses ensures that the scale of business operations is accurately captured. Since operational risk is present in both profitable and loss-making activities, this mathematical treatment prevents negative interest margins from reducing the business indicator, reflecting that high transaction volumes carry risk.

5. (B) They shall be included in the operational loss data set.
Regulatory standards require comprehensive capturing of all operational risk events within the internal loss dataset. When operational failures contribute to credit-related losses that are not explicitly accounted for under the credit risk-weighted assets framework, they must be recorded as operational losses. This ensures no risk exposure is overlooked while maintaining clear boundaries between different regulatory capital components.

6. (B) The BIC scales using progressively higher marginal coefficients as the BI crosses specific bucket thresholds.
The calculation of the business indicator component follows a progressive structure where the capital charge increases more than proportionally with the size of the institution. This is achieved through three distinct buckets, each applying a higher marginal coefficient to the portion of the business indicator within that range, starting at twelve percent and rising to eighteen percent.

7. (B) The risk of loss resulting from failed internal processes, people and systems or from external events, including legal risk but excluding strategic and reputational risk.
Operational risk is formally defined as the potential for financial loss resulting from inadequate or failed internal processes, human factors, and technical systems, or from external events. This specific regulatory definition explicitly includes legal risk, covering fines and settlements, but intentionally excludes strategic and reputational risks from the quantitative capital calculation framework to maintain consistency.

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25. (B) Income derived from insurance activities and insurance claims in favour of the bank is included.
Gross income for the basic indicator approach is defined by specific inclusions and exclusions. While reversals of provisions, profits from held-to-maturity securities, and income from property disposal are excluded, income from insurance activities or claims must also be excluded. Stating that insurance-related income is included is incorrect, as this measure focuses strictly on core banking income.

26. (D) The loss after accounting for recoveries, where recoveries reduce losses only after the bank receives the actual payment.
In building an operational risk dataset, net loss is determined by subtracting recoveries from the total gross loss. A crucial requirement for this calculation is that recoveries can only be used to reduce the reported loss amount after the bank has actually received the payment. Anticipated or pending receivables do not qualify as recoveries until the funds are settled.

27. (A) The date when a legal reserve is established for the probable estimated loss in the bank's Profit and Loss financial statement.
For the purpose of operational loss data collection, the date of accounting for legal events is specifically defined as the point when a financial impact is recognized. This corresponds to the date when a legal reserve or provision is established in the bank's profit and loss statement to cover the estimated cost of a potential settlement.

28. (A) Legacy approaches used Gross Income as a proxy, leading to lower capital requirements when income declines due to operational events. The transition to the new standardized approach was primarily driven by the limitations of using gross income as a risk proxy. Under older methods, a significant operational loss could reduce a bank's gross income, which inadvertently led to a lower capital requirement. The new framework addresses this by using a more robust business indicator and internal loss data.

29. (C) Reputational risk
The formal regulatory definition of operational risk encompasses losses from internal process failures, human errors, system breakdowns, and external events. While legal risk is explicitly included due to its measurable financial impact from fines and settlements, other types of risk such as strategic risk and reputational risk are excluded from this specific category for regulatory capital purposes.

30. (D) ORC requirement shall be equal to the Business Indicator Component (BIC).
For institutions categorized in the smallest business volume tier, known as bucket one, the internal loss multiplier is not applied. In these cases, the operational risk capital requirement is simply equal to the business indicator component. This simplifies the calculation for smaller banks while still ensuring a capital buffer that is proportional to their overall scale of operations.

31. (C) Included in gross loss — Provisions or reserves accounted for in the Profit and Loss against potential operational loss impact
The computation of gross operational losses requires including all recognized financial impacts in the profit and loss account. This specifically includes provisions or reserves established against potential operational risk events. Other items like insurance premiums are excluded as they are business expenses, while direct charges and impairments related to specific events are mandatory components of the loss.

NODIA

32. (A) (I), (II), and (IV)
Under the basic indicator approach, gross income is measured before any provisions and includes items like legal settlements in the bank's favor. It must exclude realized profits or losses from the sale of securities in the held-to-maturity category. Conversely, it should be calculated gross of operating expenses and exclude the reversal of provisions made in previous years.

33. (B) P-4, Q-3, R-1, S-2
Financial statement items are mapped to specific business indicator components for capital calculation. Interest income captures

macro-components derived from financial statement items. The final value used for capital calculations is determined by taking the average of these components over the most recent three-year period.

17. (A) Costs of repair or replacement incurred to restore the position that was prevailing before the operational risk event occurred.
Gross loss calculations for operational risk must include all direct financial impacts resulting from an event. Specifically, expenses incurred for the repair or replacement of assets to restore the bank to its position before the incident are included. In contrast, costs for future business enhancements, insurance premiums, and general risk assessment initiatives are excluded as they are not losses.

18. (C) 12.5
To convert the calculated operational risk capital requirement into risk-weighted assets, a standard regulatory multiplier is used. This factor is derived from the inverse of the minimum total capital ratio of eight percent. Consequently, the operational risk capital charge is multiplied by twelve point five to arrive at the final risk-weighted assets used for determining the adequacy ratio.

19. (D) Losses related to divested activities are strictly subjected to the minimum operational risk loss database retention period of three years.
While banks can request the exclusion of certain operational losses that no longer reflect their risk profile, specific rules apply. Generally, losses must remain in the database for a minimum period, and exclusions are subject to materiality thresholds. However, losses associated with business activities that have been entirely divested do not necessarily face the same three-year retention requirement.

20. (A) The Loss Component (LC) is equal to 15 times the average annual operational risk losses.
The loss component is a fundamental part of the internal loss multiplier calculation and is defined as fifteen times the bank's average annual operational risk losses. This calculation typically utilizes ten years of high-quality historical data. It allows the capital requirement to be scaled based on actual loss experience relative to the size of the bank's business indicator.

21. (C) II, III, I
The regulatory framework for operational risk provides several methodologies that vary in complexity and risk sensitivity. The basic indicator approach is the most rudimentary, followed by the standardized approach which divides activities into business lines. The advanced measurement approaches represent the most sophisticated level, allowing banks to utilize internal models and loss data to determine their specific capital requirements.

22. (C) Eight
Under the standardized approach for operational risk, all banking activities are categorized into eight distinct business lines. These include corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage. Each line is assigned a specific beta factor that reflects the expected industry-wide operational risk intensity for that activity.

23. (D) A proxy for the industry relationship between a business line's loss experience and its aggregate gross income.
In the standardized approach, the beta factor serves as a fixed regulatory constant for each business line. It represents the industry-wide relationship between the scale of business activity, measured by gross income, and the typical operational risk losses associated with that activity. These factors allow for a more granular capital calculation than the simpler basic indicator approach.

24. (D) Interest income from financial and operating leases
The calculation of the business indicator components relies on specific financial statement items. Interest income derived from financial and operating leases is explicitly included within the interest, lease, and dividend component. Other items, such as insurance-related income, recovery of administrative expenses, or changes in goodwill, are excluded from the business indicator to focus on core banking risk.

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insurance claim has been approved for 3 units, but the payment has not yet been received. What amount should Bank Zenith recognize as the "gross loss" for this event in its loss data set?

(A) 13 units
(B) 12 units
(C) 7 units
(D) 10 units

May/June 2017

68. Based on the scenario in Question 65, what is the calculated ORC for this bank?

(A) 17,250 units
(B) 15,000 units
(C) 13,043 units
(D) 16,500 units

Oct/Nov 2005

69. Referring to the bank in Question 66, what is the calculated value of the BIC?

(A) 45,600 units
(B) 46,560 units
(C) 54,000 units
(D) 47,760 units

May/June 2020

70. Once the insurance payment of 3 units is actually received by Bank Zenith in the scenario described in Question 67, how does it affect the loss data set parameters?

(A) It reduces the gross loss amount to 7 units once the actual settlement occurs.
(B) It acts as an independent recovery event that reduces the reported net loss amount to 7 units.
(C) It is ignored as it is an insurance recovery, which is strictly excluded from all net calculations.
(D) It is added to the general maintenance budget to offset the initial costs incurred by the bank.

NODIA

revenue from hedge accounting derivatives, while interest-earning assets include the total gross outstanding loans. Dividend income is sourced from non-consolidated subsidiaries, and other operating income includes gains from non-current assets held for sale, ensuring a comprehensive view of operational scale.

34. (D) Assertion (A) is false, but Reason (R) is true.
While building an operational loss dataset, a bank cannot immediately reduce its reported losses based on anticipated insurance receivables. Regulatory standards treat recoveries as independent events that must be verified through actual payment. Therefore, while the reason accurately describes the nature of recoveries, the assertion is false because it incorrectly suggests that pending receivables can be used.

35. (D) Neither (I) nor (II)
Regulatory guidelines for excluding operational losses from a dataset involve strict criteria. Typically, an event must have been included in the database for a minimum period, often three years, before an exclusion request is considered. Furthermore, any materiality thresholds applied for exclusion are determined by national supervisors and do not match the specific percentage or immediate discovery terms.

36. (A) 48.75 units
To determine the operational risk capital requirement using the basic indicator approach, only years with positive gross income are used. For this scenario, the two positive years are four hundred and two hundred and fifty, resulting in an average of three hundred and twenty-five. Applying the fifteen percent alpha factor to this average yields a capital requirement of forty-eight point seventy-five.

37. (A) P-2, Q-3, R-1, S-4
The operational risk framework utilizes specific mathematical definitions for its components. The loss component is defined as fifteen times the average annual losses, while risk-weighted assets are derived by multiplying capital by twelve point five. The internal loss multiplier follows a logarithmic formula comparing losses to the business indicator, and the minimum data inclusion threshold is often set.

38. (B) (I), (II), and (IV)
Previous methodological approaches for operational risk capital were criticized for several fundamental flaws. They often used gross income in a way that could lead to reduced capital requirements following large losses. Additionally, the assumption of a linear relationship between income and risk was considered inaccurate, and the variety of methods used by different banks hindered effective regulatory comparison.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Legal risk is a core component of the operational risk definition under standardized regulatory guidelines. It encompasses financial losses arising from legal actions, including fines, penalties, and settlements resulting from both supervisory interventions and private litigation. Because these events represent failures in internal compliance or external conduct, they are considered integral to the calculation of capital.

40. (D) Commercial banking — 12%
The standardized approach assigns specific beta factors to eight business lines based on their risk profile. Corporate finance, trading and sales, and payment and settlement are assigned eighteen percent. Agency services and commercial banking are assigned fifteen percent, while retail banking, asset management, and retail brokerage carry twelve percent. Stating commercial banking has twelve percent is incorrect.

41. (B) -30 units
Within the standardized approach, the capital charge for each business line is calculated by multiplying its annual gross income by its designated beta factor. For the commercial banking business line, which carries a fifteen percent factor, a reported gross income of negative two hundred units results in a specific capital charge component of negative thirty units for that period.

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42. (C) P-2, Q-4, R-3, S-1
Various factors and coefficients define the operational risk capital calculation. Alpha is the fixed percentage used in the basic indicator approach, while beta serves as the risk proxy for specific business lines under the standardized approach. Marginal coefficients scale the business indicator component across different buckets, and twelve point five is the standard multiplier used for capital.

43. (D) (II) and (IV)
In calculating gross operational losses, regulatory guidelines differentiate between direct impacts and other business expenditures. Costs associated with enhancing business infrastructure after a loss and general insurance premiums are excluded as they are not direct financial impacts of a risk event. Conversely, restorative costs and certain timing losses are included to accurately reflect the financial damage caused.

44. (A) (I) and (II) only
The standardized approach utilizes gross income as a proxy for business scale within eight defined business lines. A key feature of this method is the ability to offset negative capital charges in one business line against positive ones in others during the same year without limit. However, the final total capital requirement is based on a three-year average calculation.

45. (C) 325 units
Under the basic indicator approach, calculating the average gross income involves identifying the financial years with positive results. In this specific scenario, the bank reported four hundred units and two hundred and fifty units in years one and three, respectively. Summing these and dividing by the two qualifying years results in a calculated average gross income of three hundred and twenty-five.

46. (B) P-3, Q-4, R-2, S-1
The business indicator is the sum of three distinct macro-components. The interest, lease, and dividend component uses a capped interest margin plus dividend income. The services component is based on the maximum of specific income and expense items. The financial component reflects the absolute value of net profits and losses in the trading and banking books.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Regulatory frameworks have transitioned from gross income to the business indicator to enhance the stability and accuracy of operational risk capital. The previous reliance on gross income was flawed because significant operational events could reduce income, leading to an inappropriate decrease in required capital. The business indicator provides a more consistent proxy for business scale and risk.

48. (B) Fee and commission expenses — Schedule 14 (I)
Standard banking reporting formats utilize numbered schedules to categorize financial items. Interest income and interest expenses are typically found in schedules thirteen and fifteen, respectively, while other operating income is reported in schedule fourteen. Fee and commission expenses, however, are categorized under operating expenses in schedule sixteen rather than being part of the other income schedule identified.

NODIA

49. (A) (I), (III), and (IV)
The business indicator components are specifically derived from items related to core banking services and financial activities. Corporate income tax, impairments or reversals of impairments on financial assets, and the recovery of administrative expenses on behalf of customers are excluded from this calculation. These items do not reflect the transactional scale or service-based operational risk exposure required.

50. (B) (I) and (III) only
When calculating the business indicator, several profit and loss items are intentionally omitted to focus on banking-specific operational risk. Income and expenses from insurance businesses and general administrative or staff expenses are excluded from the components. In contrast, depreciation related to operating lease assets is included as part of the other operating expenses within the services component calculation.

51. (D) 120 units
In the standardized approach, the capital charge for a specific business line is determined by applying its regulatory beta factor to its annual gross income. For the retail banking business line, the established beta factor is twelve percent. Applying this factor to a reported gross income of one thousand units results in a specific capital charge of one hundred and twenty.

52. (D) Services Component — Clearing and settlement fee income
The services component of the business indicator is designed to capture risks associated with fee-based activities and other operations. Clearing and settlement fee income is a standard sub-item included within this component. Other items like depreciation of leased assets or advisory fees are mapped to different components or specific calculation rules within the interest, lease, and dividend framework.

53. (C) Both (I) and (II)
Operational risk capital requirements are determined based on a bank's size and data availability. For smaller institutions in bucket one, the requirement is simply the business indicator component. For larger banks in buckets two and three that maintain at least five years of high-quality internal loss data, the capital is calculated by multiplying the business indicator component by the multiplier.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The basic indicator approach excludes years with negative or zero gross income from both the numerator and the denominator of the capital calculation. This rule is essential because including negative values would decrease the average gross income, resulting in a lower capital charge. Such a reduction would be inappropriate as negative income does not imply lower risk exposure.

55. (B) (I), (II), and (IV)
Effective operational loss data collection requires capturing all material activities and exposures across the bank's systems. This includes setting a minimum threshold for event inclusion, often one lakh rupees, and excluding impacts paid by outsourcers. However, the date when a loss results in a recognized reserve is defined as the date of accounting, rather than being the discovery date.

56. (A) P-3, Q-2, R-1, S-4
The standardized approach utilizes specific beta factors to reflect the operational risk of different banking activities. Corporate finance is assigned the highest factor of eighteen percent, while agency services are assigned fifteen percent. Retail banking carries a lower factor of twelve percent. These percentages are applied to the gross income of each line to determine the specific capital charge.

57. (B) 2
In calculating the average gross income for the basic indicator approach, the denominator represents the number of years for which the annual gross income was positive. Since the bank in this scenario reported positive figures in two years and a negative figure in one year, only the two positive years are counted. Therefore, the correct denominator for this averaging calculation is two.

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58. (A) Only (I)
The basic indicator approach determines capital by taking a three-year average of a fixed percentage of positive annual gross income. It is a fundamental requirement that any year with negative or zero gross income must be excluded from both the total sum and the count of years used for the average. This ensures the capital requirement is based on positive income.

59. (B) (I), (IV), and (V)
Gross loss for operational risk is defined before any recoveries and includes events related to market risk. For consistency, foreign currency impacts must be converted using exchange rates from the accounting period. While pending losses in suspense accounts are included in the dataset, receivables cannot be treated as recoveries to reduce losses until the actual payment is received by the bank.

60. (B) (I) and (III) only
Operational loss datasets must include risk events related to market risk to ensure full

coverage of potential failures. For outsourced activities, financial impacts paid by the third-party provider are excluded from the bank's own loss records. However, operational events that contribute to credit risk and are already captured within credit risk-weighted assets are excluded to avoid double counting.

61. (C) 15,000 units
Under the standardized framework, the internal loss multiplier is used to adjust capital only when a bank has at least five years of high-quality internal loss data. If an institution possesses only four years of such data, the internal loss multiplier is effectively set to one. Consequently, the operational risk capital requirement for the bank would be exactly its component.

62. (A) BIC = (8,000 times 12%) + (2,32,000 times 15%) + (60,000 times 18%)
The business indicator component is calculated using a tiered approach with progressive marginal coefficients. For a total business indicator of three hundred thousand, the first eight thousand is charged at twelve percent. The next segment, up to two hundred and forty thousand, is charged at fifteen percent. The remaining amount exceeding the second bucket threshold is charged at eighteen percent.

63. (C) 180 units
To calculate the aggregate capital charge under the standardized approach for a single year, the charges for all business lines are summed. In this case, the individual charges of one hundred and twenty for retail banking, negative thirty for commercial banking, and ninety for corporate finance are added together. This results in a total aggregate capital charge of one hundred and eighty.

64. (C) 10 units
In an operational risk event, the net loss is the gross loss minus any received recoveries. Before an insurance payment is actually received, the net loss remains equal to the gross loss amount. In this fraud scenario, the direct legal settlement of ten units constitutes the gross loss, and since the insurance recovery is pending, the reported net loss is ten.

65. (B) Since the bank has five years or more of high-quality data, ORC is calculated by multiplying the BIC by the ILM.
Banks in buckets two and three are required to use internal loss data in their capital calculations if they have at least five years of high-quality historical records. Since the bank in this scenario has eight years of such data, it must calculate its operational risk capital by multiplying the business indicator component by the internal loss multiplier to reflect risk.

66. (C) Bucket 3
The standardized approach categorizes banks into buckets based on the size of their business indicator. Bucket one includes indicators up to eight thousand, while bucket two covers the range from eight thousand to two hundred and forty thousand. Any bank with a business indicator exceeding two hundred and forty thousand, such as the three hundred thousand here, is classified in bucket three.

67. (D) 10 units
Gross loss is defined as the total financial impact of an operational risk event before any recoveries. For this internal fraud event, the direct legal settlement of ten units is included. However, internal expenditures for security system upgrades and general maintenance are excluded as they are considered business enhancements or standard operating costs rather than direct losses from the event.

68. (A) 17,250 units
The final operational risk capital requirement for a bank with sufficient loss data is the product of its business indicator component and the internal loss multiplier. By applying the calculated multiplier of one point fifteen to the business indicator component of fifteen thousand units, the resulting capital requirement for the institution is seventeen thousand two hundred and fifty.

69. (B) 46,560 units
To find the total business indicator component, marginal coefficients are applied to the portion of the indicator falling within each bucket. For an indicator of three hundred thousand, this involves twelve percent of eight thousand, fifteen percent of two hundred and thirty-

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two thousand, and eighteen percent of sixty thousand. Summing these segments results in a total value of forty-six thousand five hundred and sixty.

70. (B) It acts as an independent recovery event that reduces the reported net loss amount to 7 units.

Once a bank actually receives an insurance payment related to a previously recorded operational risk event, the payment is treated as a recovery. This recovery does not change the original gross loss figure but is used to reduce the net loss reported in the dataset. In this case, receiving three units reduces the previous net loss to seven.

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NODIA

of sophistication adopted in the ICAAP regarding risk measurement and management to be commensurate with the nature, scope, scale and complexity of the bank's business operations.
Reason (R): The implementation of ICAAP should be guided by the principle of proportionality, categorizing operations as simple, moderately complex, and complex.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2024

48. Identify the incorrectly matched pair regarding roles and responsibilities in the ICAAP framework.
(A) Board of Directors - Holds the ultimate responsibility for designing and implementation of the ICAAP.
(B) Chief Risk Officer - Reports directly to the heads of the individual business lines to facilitate faster credit approvals.
(C) Senior Management - Identifies all weaknesses in the ICAAP and develops remediation plans with specific timelines.
(D) Bank Management - Responsible for understanding the nature and level of risk being taken in relation to adequate capital levels.

May/June 2019

49. Read the following statements regarding Interest Rate Risk on the Banking Book (IRRBB). The main components of the measurement approach include:
(I) The assessment should take into account both the earnings perspective and economic value perspective of interest rate risk.
(II) The impact on income or economic value of equity should be calculated by applying a notional interest rate shock of 200 basis points.
(III) Banks typically use the Gap to measure interest rate risk from an earning perspective.
(IV) A level of interest rate risk generating a drop in MVE of more than 20% with a 200 basis points shock is treated as excessive.
(V) Banks with excessive IRRBB would normally be required by the regulator to hold additional capital against it as determined during the SREP.
Which of the above statement(s) is/are correct?
(A) (I), (II), IV), and (V) only
(B) (I), (III), (IV), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2008

50. Read the following statements regarding risks in trading activities. To determine risks resulting from a movement in market prices, a bank should consider which of the following factors?
(I) Illiquidity of instruments and concentrated positions.
(II) One-way markets.
(III) Non-linear/deep out-of-the money positions and the potential for significant shifts in correlations.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II)
(B) Only (I) and (III)
(C) Only (II) and (III)
(D) (I), (II), and (III)

May/June 2005

51. Read the following scenario and answer the question that follows:
Zenith Bank wants to calculate the impact of standard interest rate shocks on its market value of equity (MVE) as part of its Interest Rate Risk in the Banking Book (IRRBB) assessment. According to the approach prescribed for measurement, what notional interest rate shock should the bank apply to calculate this impact?
(A) A notional shock of 50 basis points.
(B) A notional shock of 100 basis points.
(C) A notional shock of 400 basis points.
(D) A notional shock of 200 basis points.

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Oct/Nov 2024

6. From a prudential viewpoint, which measurement is considered a top priority when performing stress tests that relate to interest rate risks in the banking book?
(A) The impact on the historical cost of equity.
(B) The measurement of the impact on economic value.
(C) The absolute number of unresolved customer complaints.
(D) The short-term daily volatility of the foreign exchange rate.

May/June 2019

7. What comprises a bank's procedures and measures designed to ensure an appropriate identification and measurement of risks, an appropriate level of internal capital in relation to the risk profile, and the application of suitable risk management systems?
(A) Supervisory Review and Evaluation Process (SREP)
(B) Internal Capital Adequacy Assessment Process (ICAAP)
(C) Market Discipline Architecture
(D) Base Scenario Minimum Capital Requirement

Oct/Nov 2008

8. Which of the following statements is correct regarding the assessment of capital adequacy for market risk in more sophisticated institutions?
(A) It should strictly avoid value-at-risk modelling to ensure credit risk is not significantly underestimated.
(B) It should use value-at-risk modelling and stress testing, assessing concentration risk and illiquidity under stress.
(C) It should rely on historical loss experience without including stress testing or portfolio concentration risk.
(D) It must ignore illiquid and one-way positions as they cannot be measured accurately under Pillar 2 standards.

May/June 2005

9. The sophistication of the methodologies used to quantify credit risk should take into consideration all of the following minimum factors EXCEPT:
(A) Historical loss experience
(B) Duration gap analysis of off-balance sheet derivatives
(C) Attributes specific to a defined group of borrowers
(D) Forecast and past economic conditions

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Oct/Nov 2011

10. What does the principle of proportionality imply regarding the implementation of ICAAP?
(A) The requirement that ICAAP frameworks remain uniformly complex across all institutions regardless of size.
(B) The mandate to allocate capital to internal departments based strictly on total staff count and overhead.
(C) The ICAAP sophistication should match the nature, scale, and complexity of a bank's business operations.
(D) The supervisory policy of applying identical remedial actions to all banks failing to meet capital ratios.

May/June 2012

11. Standard regulatory guidelines for Asset Liability Management (ALM) assess net cumulative negative mismatches for different short-term buckets. Arrange the following time buckets in ascending chronological order:
1. 8-14 days
2. Next day
3. 15-28 days
4. 2-7 days

(A) 2, 4, 1, 3
(B) 4, 2, 3, 1
(C) 1, 3, 2, 4
(D) 2, 1, 4, 3

Oct/Nov 2017

12. On which date did the Reserve Bank of India adopt the revised framework of the Basel II capital accord issued by the Basel Committee on Banking Supervision?
(A) November 15, 2005
(B) June 26, 2004
(C) April 27, 2007
(D) February 19, 2003

May/June 2023

13. Which of the following statements incorrectly outlines what a bank's policies, procedures, and limits should ensure under its risk strategy?

below minimum levels.
3. Banks should have a process for assessing overall capital adequacy in relation to their risk profile.
4. Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies.

(A) P-3, Q-4, R-1, S-2
(B) P-4, Q-3, R-2, S-1
(C) P-1, Q-2, R-3, S-4
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2007

38. Read the following statements regarding the board of directors' assessment of ICAAP. The board shall assess whether the processes successfully achieve envisaged objectives. Areas that should be reviewed include:
(I) Appropriateness of the bank's capital assessment process given the nature, scope and complexity of its activities.
(II) Identification of large exposures and risk concentrations.
(III) Accuracy and completeness of data inputs into the bank's assessment process.
(IV) Reasonableness and validity of scenarios used in the assessment process.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

May/June 2016

39. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer using the codes given below:
Assertion (A): The ICAAP should be forward-looking in nature, taking into account expected future developments such as strategic plans and macro-economic factors.
Reason (R): It is important to ensure that ICAAP facilitates risk-adjusted growth of the institution and does not become a limitation for the growth and versatility of the banks.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2018

40. Identify the incorrectly matched pair regarding the HHI Index value and the corresponding Level of Risk.
(A) $<$ 1000 – Low Risk
(B) 1000 – 1800 – Moderate Risk
(C) $>$ 1800 – High Risk
(D) $<$ 1000 – Moderate Risk

May/June 2010

41. Read the following scenario and answer the question that follows:
During a stress test, Zenith Bank observes that the applied interest rate shock results in a 22% drop in its Market Value of Equity (MVE). How will this outcome be treated by the regulatory framework, and what consequence is likely during the Supervisory Review and Evaluation Process (SREP)?
(A) It will be treated as normal, requiring only a documentation update.
(B) It will be treated as excessive, and the bank would normally be required by the regulator to hold additional capital against IRRBB.
(C) It will be treated as optimal, allowing the bank to release excess capital reserves.
(D) It will be treated as moderate, requiring the bank to merely modify its internal pricing mechanisms without capital impact.

Oct/Nov 2021

42. Match the Export Credit Guarantee Corporation (ECGC) Risk Category Classifications (List I) with their required Provisioning Percentage (List II) for country risk exposures:
List I: (ECGC Risk Categories)
P. A1
Q. B1
R. B2
S. C1
List II: (Provisioning Percentage)
1. 20.00%

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Oct/Nov 2015

20. Which of the following correctly describes a responsibility of the senior management concerning ICAAP?

(A) Senior management is responsible for ensuring that ICAAP activities authorized by the board are implemented in a satisfactory manner.

(B) The ultimate responsibility for designing and implementation of the ICAAP lies with the senior management.

(C) Senior management should define the institution's risk appetite without consulting the board of directors.

(D) Senior management must independently conduct the Supervisory Review and Evaluation Process (SREP) on behalf of the regulator.

May/June 2025

21. The steps in developing a suitable risk management process from defining the risk appetite to setting limits can be summarized broadly. What is the correct chronological sequence for the first three steps of this process?

(A) Setting internal limits, formulating the overall risk appetite, and assigning limits to individual risk categories.

(B) Assigning limits to risk categories, defining those limits, and then formulating the overall risk appetite.

(C) Defining high-level risk appetite, setting limits based on that appetite, and assigning limits to business lines.

(D) Validating the expected utilization of limits, formulating risk appetite, and defining the specific limits.

Oct/Nov 2023

22. Under Pillar 1 of the Basel II framework, which of the following risks was explicitly included for the first time in the risk-sensitive calculation of capital requirements?

(A) Credit Risk

(B) Operational Risk

(C) Market Risk

(D) Strategic Risk

May/June 2009

23. On what should a bank base the future development of its target risk structure?

(A) The historical risk structures of comparable peer institutions that operate in different global markets.

(B) The immediate short-term fluctuations of market interest rates and general macroeconomic indicators.

(C) The qualitative parameters established by the risk department without consultation from the board.

(D) The bank's planned business structure and strategy, ensuring consistency between business and risk goals.

NODIA

Oct/Nov 2014

24. Interest rate risks in the banking book include all of the following types EXCEPT:

(A) Repricing risk

(B) Basis risk

(C) Option risk

(D) Counterparty settlement risk

May/June 2014

25. Which of the following statements incorrectly identifies the coverage of risks under ICAAP?

(A) It covers specific risks that are not fully captured by the minimum capital ratio defined under Pillar 1.

(B) It mandates a fixed, identical capital buffer for all banks regardless of their individual risk profiles.

(C) It covers various risk categories that are not taken into account at all by the Pillar 1 framework.

(D) It covers significant environmental or economic factors that are external to the bank's daily operations.

Oct/Nov 2010

26. Which of the following accurately describes residual credit risk?

(A) The probability that a counterparty fails to perform on a contract due to deteriorating creditworthiness.

(B) The risk that public expectations regarding the bank's integrity will change negatively, causing a loss of clients.

(C) The risk resulting from mismatched maturity structures of assets and liabilities priced across different intervals.

(D) Risk where credit risk mitigation techniques become ineffective for reasons other than the default of the guarantor.

(A) Ensure there is no separation between business lines and the risk function to streamline cross-departmental accountability.
(B) Provide for adequate and timely identification, measurement, monitoring, control and mitigation of risks.
(C) Escalate and address breaches of internal position limits.
(D) Include a schedule and process for reviewing the policies, procedures and limits and for updating them as appropriate.

Oct/Nov 2005

14. Which of the following statements correctly identifies one of the key principles laid down by the Basel Committee for the Supervisory Review Process under Pillar 2?
(A) Principle 1 states that supervisors must review and evaluate a bank's internal capital assessments and strategies.
(B) Principle 2 states that banks should possess a process for assessing overall capital adequacy relative to risk.
(C) Principle 3 states that supervisors should expect banks to operate above minimum ratios and hold excess capital.
(D) Principle 4 states that banks should intervene at an early stage to prevent capital from falling below levels.

May/June 2018

15. Which of the following provides the most appropriate description of concentration risk?
(A) The current or prospective risk to earnings arising from adverse movements in interest rates affecting both the trading and banking books.
(B) The potential inability of an institution to realize its positions at an adequate market price within a short time horizon.
(C) The risk associated with the use of collateral where the legal mechanism does not guarantee the right to seize the asset.
(D) Any single exposure or group of exposures with the potential to produce losses large enough to threaten a bank's health or ability to maintain its core operations.

Oct/Nov 2022

16. Which of the following defines the Supervisory Review and Evaluation Process (SREP)?
(A) A supervisory review of a bank's internal capital assessment and its independent risk profile.
(B) A process involving market participant monitoring of a bank's financial position and risk exposure.
(C) A process used by the board of directors to allocate capital resources across diverse business segments.
(D) A regulatory approach focused exclusively on minimum capital requirements for operational risk management.

May/June 2011

17. In the capital planning process, stress test results are advised to be used to reveal the impacts of unexpected changes in environments. These include all of the following EXCEPT:
(A) Risks from technological obsolescence
(B) Earnings risk
(C) Risks from the economic environment
(D) Risks of the regulatory environment

Oct/Nov 2019

18. In respect of country risk management, at what threshold of net funded exposure as a percentage of total assets is a bank currently required to make provisions?
(A) 0.25% or more
(B) 0.50% or more
(C) 1.00% or more
(D) 5.00% or more

May/June 2013

19. Which of the following statements is incorrect regarding stress tests related to interest rate risks in the banking book?
(A) The institution should regularly analyze the potential impact of sudden and unexpected interest rate changes.
(B) The measurement of the impact on economic value should be considered a top priority for prudential oversight.
(C) The measurement of profitability is vital because profitability changes can influence long-term bank solvency.
(D) Shocks should be modeled for any currency where off-trading book items exceed 10% of total banking book volume.

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S. Option risk

List II: (Defining Characteristics)

1. Derives from the change of relations between the interest rates of two external benchmarks.
2. Originating in changes of the shape and steepness of the yield curve.
3. Deriving from interest-related rights inherent in banking products allowing a client to change conditions.
4. Deriving from the different maturity structure of assets and liabilities.

(A) P-4, Q-1, R-2, S-3
(B) P-1, Q-4, R-3, S-2
(C) P-4, Q-2, R-1, S-3
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2009

34. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer using the codes given below:

Assertion (A): The detection of concentration threats with stress testing is of outstanding importance in risk management.

Reason (R): Under normal business conditions, concentration risks rarely cause problems as concentration mostly remains in the background.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2008

35. Read the following statements regarding capital calculation for Credit Risk:

(I) In many jurisdictions, most banks have adopted the Standardized Approach for the calculation of capital.
(II) Institutions applying the standardized approach are expected to ensure that the adequacy of classification according to exposure classes be supported by regulations and documentation.

Which of the following is correct?

(A) Both Statement (I) and Statement (II) are true.
(B) Both Statement (I) and Statement (II) are false.
(C) Statement (I) is true, but Statement (II) is false.
(D) Statement (I) is false, but Statement (II) is true.

Oct/Nov 2016

36. Read the following scenario and answer the question that follows:

To prepare for unexpected emergency situations predicted in stress scenarios, Apex Bank creates a liquidity buffer using high-quality liquid assets. However, a junior executive argues that establishing this buffer implies the bank no longer needs to carefully manage its day-to-day funding gaps and resources. Based on ICAAP liquidity control principles, is this argument valid?

(A) No, a liquidity buffer does not substitute for careful stress preparation or management of funding gaps.
(B) Yes, maintaining a sufficient liquidity buffer completely removes the need for operational funding gap management.
(C) Yes, the primary purpose of the buffer is to allow the bank to overlook day-to-day cash flow discrepancies.
(D) No, because the liquidity buffer must only be utilized for covering credit default risks, not funding gaps.

May/June 2017

37. Match the Basel II Supervisory Review Process Principles (List I) with their respective descriptions (List II):

List I: (Supervisory Review Process Principles)

P. Principle 1
Q. Principle 2
R. Principle 3
S. Principle 4

List II: (Descriptions)

1. Supervisors should require banks to hold capital in excess of the minimum and operate above minimum ratios.
2. Supervisors should seek to intervene at an early stage to prevent capital from falling

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May/June 2022

27. Why is operational risk considered more complex to measure compared to other forms of risks?

(A) It has to do with the competency of the staff and is inherently difficult to measure.

(B) It is generated only when there is a mismatch between the maturity structure of assets and liabilities.

(C) It involves complex non-linear mathematical models that require daily calibration.

(D) It requires continuous mark-to-market valuations of trading book portfolios.

Oct/Nov 2020

28. Why is capital viewed as a risk mitigator in the context of the banking system?

(A) It helps protect banks from insolvency, promoting the overall safety and soundness of the banking system.

(B) It provides a formal guarantee that an institution will never encounter strategic or operational failures.

(C) It removes the necessity for maintaining internal control mechanisms and standardized reporting frameworks.

(D) It transfers the entirety of a bank's market risk to its uninsured lenders and external rating agencies.

May/June 2020

29. According to the risks analyzed under the ICAAP framework, all of the following are categorized as Pillar II risks EXCEPT:

(A) Interest Rate Risk on Banking Book

(B) Concentration Risk

(C) Operational Risk

(D) Reputation Risk

Oct/Nov 2025

30. Which of the following statements is correct regarding the structural aspects of the ICAAP preparation within a banking group?

(A) The ICAAP must be prepared exclusively at the level of the consolidated bank to prevent internal redundancy.

(B) The ICAAP should be prepared solely at the solo level for the parent bank, thereby exempting its subsidiaries.

(C) The ICAAP is an optional framework applicable only to complex universal banks and not to specialized entities.

(D) The ICAAP should be prepared at every tier for each banking entity and at the level of the consolidated bank.

May/June 2024

31. Identify the correctly matched pair regarding the components of country risk.

(A) Transfer risk - Occurs when an event impacting the whole country leads to default by a large group of debtors.

(B) Collective debtor risk - The obligor of a contract is unable to meet payment obligations in contractual currency despite having necessary local currency.

(C) Sovereign risk - Derives from the insolvency of the country in which the institution has an exposure.

(D) Market discipline risk - The government intervenes to artificially lower overseas borrowing costs.

Oct/Nov 2012

32. Read the following statements regarding sound risk management systems. A system encompassing a firm-wide risk profile should have which of the following key features?

(I) Active board and senior management oversight.

(II) Appropriate policies, procedures and limits.

(III) Comprehensive and timely identification, measurement, mitigation, controlling, monitoring and reporting of risks.

(IV) Appropriate management information systems (MIS) at the business and firm-wide level.

(V) Comprehensive internal controls.

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (IV) only

(B) (I), (II), (IV), and (V) only

(C) (II), (III), (IV), and (V) only

(D) (I), (II), (III), (IV), and (V)

NODIA

May/June 2006

33. Match the types of interest rate risks (List I) with their defining characteristics (List II):

List I: (Types of Interest Rate Risks)

P. Repricing risk

Q. Basis risk

R. Yield curve risk

2. 5.00%
3. 0.25%
4. 25.00%

(A) P-3, Q-2, R-1, S-4
(B) P-2, Q-3, R-4, S-1
(C) P-1, Q-4, R-2, S-3
(D) P-3, Q-1, R-2, S-4

May/June 2021

43. Read the following statements regarding risk management reviews. As a minimum, a bank shall conduct periodic independent reviews of its risk management processes. These reviews should ensure:

(I) The integrity, accuracy, and reasonableness of the processes.
(II) The timely identification of any concentration risk.
(III) The accuracy and completeness of any data inputs into the bank's capital assessment process.
(IV) That the bank conducts appropriate stress testing.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (IV) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2006

44. Read the following statements regarding Reputation Risk:

(I) Reputation risk is the risk that stakeholders will negatively change their expectations and behavior, which may result in the bank losing money, customers and business.
(II) It impacts the balance sheet very gradually and the organization will not even know about it.
(III) Reputation risk is considered a derivative risk because any risk event—market, credit, operational, or strategic—can have a reputational impact.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II)
(B) Only (I) and (III)
(C) Only (II) and (III)
(D) (I), (II), and (III)

May/June 2015

45. Read the following scenario and answer the question that follows:

The risk manager at Apex Bank presents a liquidity report showing the net cumulative negative mismatches for the 8-14 days bucket. The calculated mismatch is -24% of the cumulative cash outflows. Based on the stipulated limits under standard Asset Liability Management (ALM) policies and regulatory guidelines, what is the appropriate assessment of this metric?

(A) It is within acceptable limits, as the maximum permissible limit for this specific bucket is currently -25%.
(B) It is within acceptable limits, as the maximum permissible limit for this specific bucket is currently -50%.
(C) It breaches the prescribed limit, as the net cumulative negative mismatch for this bucket should not exceed -20%.
(D) It breaches the prescribed limit, as no negative mismatches of any size are permitted in the 8-14 days bucket.

Oct/Nov 2013

46. Match the risk classifications (List I) with the corresponding risk types (List II) based on the ICAAP framework:

List I: (Risk Classifications)
P. Pillar 1 Risks
Q. Risks not adequately covered by Pillar 1
R. Pillar II risks
S. Other Risks

List II: (Risk Types)
1. Model Risk
2. Concentration Risk and Liquidity Risk
3. Credit Risk, Market Risk, and Operational Risk
4. Residual Risk and Securitization

(A) P-3, Q-4, R-1, S-2
(B) P-3, Q-4, R-2, S-1
(C) P-4, Q-3, R-2, S-1
(D) P-2, Q-1, R-4, S-3

May/June 2007

47. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer using the codes given below:

Assertion (A): Regulators expect the degree

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CHAPTER 28

Supervisory Review Process and Internal Capital Adequacy Assessment Process

INDIA

May/June 2021

1. How frequently shall the board of directors assess and document whether the processes relating to the ICAAP successfully achieve the objectives envisaged by the board?
(A) At least once a quarter
(B) At least once a half-year
(C) At least once a year
(D) At least once every two years

Oct/Nov 2006

2. Which of the following statements regarding the setting of internal limits for controlling Interest Rate Risk in the Banking Book (IRRBB) is incorrect?
(A) Internal limits could be fixed in terms of the maximum decline in earnings as a result of a 200 or 300 basis point interest-rate shock.
(B) Internal limits could be fixed in terms of the maximum decline in capital as a percentage of the base-scenario capital position.
(C) The limits must be placed exclusively in terms of PV01 value calculated as a fixed monetary amount independent of the net worth of the bank.
(D) A level of interest rate risk which generates a drop in the Market Value of Equity (MVE) of more than 20% with a 200 basis points shock is treated as excessive.

May/June 2015

3. How is risk appetite defined in the context of the Internal Capital Adequacy Assessment Process?
(A) The absolute maximum capital a bank can raise in the financial markets during a severe economic downturn.
(B) The regulatory capital threshold below which a bank is considered insolvent by the supervisory authority.
(C) The bank's willingness to take on financial risks as quantified by the appropriate indicators.
(D) The historical loss experience observed by the bank over a business cycle of five years.

Oct/Nov 2013

4. What is the very objective of the ICAAP process?
(A) To calculate the minimum capital requirements for credit risk strictly under the Standardized Approach.
(B) To act as a direct substitute for external audits and regular inspections by the regulatory authority.
(C) To take an integrated perspective of risk exposure to identify and react to emerging risks effectively.
(D) To focus on the quantitative measurement of historical losses without including forward-looking elements.

May/June 2007

5. How does funding liquidity risk fundamentally differ from market liquidity risk?
(A) Funding liquidity risk relates to realizing asset values, while market liquidity risk relates to fulfilling future cash-flow needs.
(B) Funding liquidity risk concerns meeting cash-flow obligations, while market liquidity risk concerns closing positions at market prices.
(C) Funding liquidity risk arises from foreign exchange activities, while market liquidity risk stems from domestic branch growth.
(D) Funding liquidity risk is mitigated by stress tests, while market liquidity risk cannot be effectively measured or tested.

Oct/Nov 2011

52. Identify the correctly matched pair regarding standard interest rate shocks recommended by the Basel Committee.
(A) Shock 2 - Steepening of yield curve (500 bps parallel shift).
(B) Shock 3 - Inversion of the yield curve (Parallel downward shift).
(C) Shock 1 - Inversion of the yield curve (200 basis points).
(D) Shock 1 - Parallel upward/downward shift of yield curve (200 basis points).

May/June 2012

53. Read the following statements regarding Capital Allocation under ICAAP:
(I) Capital allocation serves as a way of determining, aggregating and breaking down capital to the organizational units and exposures.
(II) If allocation is linked to performance measurement or pricing, it implies that the institution treats capital calculation purely as a regulatory formality rather than applying it to day-to-day operations.
Which of the following is correct?
(A) Both Statement (I) and Statement (II) are true.
(B) Both Statement (I) and Statement (II) are false.
(C) Statement (I) is true, but Statement (II) is false.
(D) Statement (I) is false, but Statement (II) is true.

Oct/Nov 2017

54. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer using the codes given below:
Assertion (A): A written record on the outcome of the ICAAP should be periodically submitted by banks to their board of directors.
Reason (R): The ICAAP is a static, one-time assessment performed solely at the inception of the bank and requires no ongoing management tracking.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2023

55. Read the following statements regarding Management Information Systems (MIS). A bank's MIS developed for aggregating risks and capital assessment should meet which of the following requirements?
(I) Support customised identification of concentrations and emerging risks.
(II) Be adaptable and responsive to changes in the bank's underlying risk assumptions.
(III) Be sufficiently flexible to generate forward-looking bank-wide scenario analyses.
(IV) Be capable of capturing limit breaches and promptly reporting such breaches to senior management.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2005

56. Match the Herfindahl-Hirschman Index (HHI) values (List I) with the corresponding level of concentration (List II):
List I: (HHI Values)
P. HHI < 1000
Q. 1000 - 1800
R. HHI > 1800
S. $\Sigma\ (MS_i)^2$
List II: (Level of Concentration)
1. Moderate concentration
2. High concentration
3. Low concentration
4. HHI Formula
(A) P-3, Q-1, R-2, S-4
(B) P-1, Q-3, R-4, S-2
(C) P-3, Q-2, R-1, S-4
(D) P-2, Q-1, R-3, S-4

May/June 2018

57. Read the following scenario and answer the question that follows:
Apex Bank is upgrading its liquidity risk management framework. The Asset Liability

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Oct/Nov 2010

68. Upon evaluating the exposure in Country X, Global Bank notes that the Export Credit Guarantee Corporation (ECGC) classification for Country X is 'B2' (Moderate). According to the graded scale for country risk provisioning, what percentage requirement applies to this net funded exposure?

(A) 20.00%
(B) 5.00%
(C) 25.00%
(D) 100.00%

May/June 2022

69. To quantitatively assess the degree of sectoral concentration in its credit portfolio, the Chief Risk Officer of Horizon Bank computes the Herfindahl-Hirschman Index (HHI) for the asset classes. The computed HHI index value is 1450. According to the standard HHI risk level classifications, how should this concentration be categorized?

(A) Low concentration (Low Risk)
(B) Moderate concentration (Moderate Risk)
(C) High concentration (High risk)
(D) Insignificant concentration (Negligible Risk)

NODIA

Oct/Nov 2020

70. Vanguard Bank's Board of Directors emphasizes that the ICAAP should not merely be a compliance exercise but should form an integral part of the management and decision-making culture. Which of the following practical applications best demonstrates this integration?

(A) Submitting the ICAAP document directly to external shareholders without performing an internal management review.
(B) Using ICAAP to allocate capital to units and letting it play a role in credit decisions and product pricing.
(C) Restricting the use of ICAAP data solely to the preparation and submission of the annual regulatory filing.
(D) Outsourcing the entirety of the risk management system to a third-party vendor to automate all credit decisions.

aggregate exposure should not exceed at any time?

(A) 800% of its Tier 1 capital
(B) 100% of its Tier 1 capital
(C) 400% of its Tier 1 capital
(D) 1000% of its Tier 1 capital

May/June 2025

63. Read the following scenario and answer the question that follows:
The Asset Liability Committee at Zenith Bank notes a trend where borrowers are choosing to prepay their fixed-rate retail loans early because market interest rates have significantly dropped. This change in client behavior modifies the bank's interest rate exposure. Which specific type of interest rate risk does this scenario primarily illustrate?

(A) Repricing risk
(B) Basis risk
(C) Option risk
(D) Yield curve risk

Oct/Nov 2023

64. Read the following scenario and answer the question that follows:
Vanguard Bank generates an overview of its actual risk structure, highlighting a significant concentration in market risk compared to credit risk. What is the primary purpose of analyzing this actual risk structure in the context of setting limits?

(A) It dictates the immediate liquidation of all trading book portfolios to zero to mitigate existing market risk.
(B) It replaces the need for calculating the daily Value-at-Risk (VaR) for the bank's entire investment portfolio.
(C) It highlights potential needs for action and provides a framework for development toward a target risk structure.
(D) It automatically exempts the bank from the Pillar 1 minimum capital requirements based on its unique structure.

May/June 2009

65. Global Bank, with total assets of ₹1,00,000 crores, is reviewing its overseas credit deployments to assess country risk. It has a net funded exposure of ₹1,500 crores in Country X. Based on standard regulatory guidelines on Country Risk Management, is Global Bank required to make provisions for this specific exposure?

(A) No, provisioning is only required if the gross exposure exceeds 5% of total assets.
(B) Yes, because the bank's net funded exposure is 1% or more of its total assets.
(C) No, because country risk provisions are strictly voluntary for foreign branches.
(D) Yes, but only if the exposure consists entirely of sovereign bonds.

Oct/Nov 2014

66. Horizon Bank has a Tier 1 capital base of ₹5,000 crores. A corporate client, ABC Enterprises, approaches the bank for a combined funded and non-funded exposure facility totaling ₹600 crores. For the purpose of assessing aggregate exposure limits to mitigate concentration risk, does ABC Enterprises qualify as a 'large borrower'?

(A) No, because the exposure is below 15% of Tier 1 capital.
(B) No, because non-funded exposures are excluded from the calculation.
(C) Any exposure above ₹500 crores is automatically classified as a large borrower regardless of capital.
(D) Yes, because the aggregate exposure exceeds 10% of the bank's Tier 1 capital.

May/June 2014

67. Vanguard Bank is structuring its firm-wide risk management hierarchy under ICAAP. The CEO proposes that the Chief Risk Officer (CRO) should report directly to the Head of Corporate Lending to ensure risk limits are aligned tightly with business targets. According to ICAAP structural guidelines, is this proposed reporting line appropriate?

(A) Yes, integrating the CRO into the lending division ensures that capital allocation remains optimal and efficient.
(B) Yes, provided that the Head of Corporate Lending also maintains a voting seat on the bank's audit committee.
(C) No, the CRO must legally report only to external rating agencies to ensure consistent market discipline.
(D) No, the risk function should be independent and report directly to the CEO/Managing Director and the board.

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Committee (ALCO) intends to run stress tests to identify and quantify exposures to possible future liquidity stresses. According to the standard advisory guidelines provided to banks, what survival period should Apex Bank use in its stress testing?

(A) A one-month survival period
(B) A one-week survival period
(C) A one-quarter survival period
(D) A one-year survival period

Oct/Nov 2022

58. Read the following statements regarding the bank's internal control structure in the capital assessment process:

(I) Better practices view the capital assessment process (CAP) controls on an integrated basis, representing a strong "second line of defense" to ensure CAP functions effectively.
(II) Effective control of the capital assessment process includes an independent review and, where appropriate, the involvement of internal or external audits.

Which of the following is correct?

(A) Both Statement (I) and Statement (II) are true.
(B) Both Statement (I) and Statement (II) are false.
(C) Statement (I) is true, but Statement (II) is false.
(D) Statement (I) is false, but Statement (II) is true.

May/June 2011

59. Read the following statements regarding the capital planning process. Which of the following items should be taken into account to ensure capital adequacy at all times?

(I) Current capital requirement of the institution.
(II) Planned capital consumption.
(III) The targeted and sustainable capital level taking into account strategy and risk appetite.
(IV) The means of capital management (internal and external resources).
(V) Other employable means of ensuring capital adequacy (e.g. budgeting of business and balance sheet items).

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (IV) only
(B) (II), (III), Reviewing IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

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Oct/Nov 2019

60. Read the following statements regarding the measurement of liquidity risk according to standard Asset Liability Management (ALM) policies:

(I) Banks measure liquidity risk through the Stock Approach and Traditional Gap Approach (Flow Approach).
(II) The net cumulative negative mismatches during the 8-14 days bucket should not exceed -20% of the cumulative cash outflows.
(III) The net cumulative negative mismatches during the 15-28 days bucket should not exceed -35% of the cumulative cash outflows.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II)
(B) Only (I) and (III)
(C) Only (II) and (III)
(D) (I), (II), and (III)

May/June 2013

61. Read the following scenario and answer the question that follows:

During its international operations, Global Bank suffers financial losses because the government of Country Y becomes insolvent and officially defaults on its sovereign debt issuances. In the context of country risk components, which specific type of risk has materialized for Global Bank?

(A) Transfer risk
(B) Collective debtor risk
(C) Sovereign risk
(D) Strategic risk

Oct/Nov 2015

62. Read the following scenario and answer the question that follows:

Following prudent practices for managing concentration risk, Horizon Bank aims to set a firm ceiling on its aggregate exposure to all its identified 'large borrowers' combined. Based on regulatory prudent practices, what is the maximum percentage of Tier 1 capital that this

ANSWERS

1. (C) At least once a year
The board of directors maintains ultimate responsibility for the Internal Capital Adequacy Assessment Process. To ensure effectiveness, they must evaluate the framework's ability to meet strategic objectives. Regulatory guidelines mandate this formal assessment and documentation occur at least once a year. This annual review helps align capital planning with the bank's evolving risk profile and business environment.

2. (C) The limits must be placed exclusively in terms of PV01 value calculated as a fixed monetary amount independent of the net worth of the bank.
Interest Rate Risk in the Banking Book management requires a multi-faceted approach to limit setting. Banks utilize various metrics, including earnings volatility and capital impact under specific interest rate shocks. Relying exclusively on PV01 is insufficient because it provides a narrow view of risk. Effective frameworks incorporate comprehensive measures to ensure capital adequacy against diverse interest rate movements.

3. (C) The bank's willingness to take on financial risks as quantified by the appropriate indicators.
Risk appetite represents a fundamental component of a bank's strategic framework, defining the types and aggregate levels of risk an institution is prepared to accept. It is quantified through specific indicators that align with the bank's business goals and capital constraints. This allows management to balance growth objectives with the necessary prudential safeguards to maintain long-term financial stability.

4. (C) To take an integrated perspective of risk exposure to identify and react to emerging risks effectively.
The Internal Capital Adequacy Assessment Process aims to provide a holistic view of a bank's risk landscape. By integrating various risk categories, it helps identify emerging threats that single-risk metrics might miss. This proactive approach ensures that the institution maintains sufficient capital to support its specific risk profile while reacting effectively to dynamic changes in the economic environment.

5. (B) Funding liquidity risk concerns meeting cash-flow obligations, while market liquidity risk concerns closing positions at market prices.
Funding liquidity risk involves the potential inability of a bank to meet its daily cash flow obligations without incurring unacceptable losses. Conversely, market liquidity risk refers to the difficulty of selling or closing out assets at prevailing market prices due to insufficient market depth. Distinguishing between these two is critical for developing robust liquidity management strategies and contingency funding plans.

6. (B) The measurement of the impact on economic value.
When conducting stress tests for interest rate risk in the banking book, assessing the impact on economic value is a primary prudential concern. This measurement captures the long-term sensitivity of the bank's net worth to interest rate fluctuations. It provides a more comprehensive view of potential capital erosion than short-term earnings metrics, ensuring the institution remains solvent under stress.

7. (B) Internal Capital Adequacy Assessment Process (ICAAP)
The Internal Capital Adequacy Assessment Process encompasses the set of measures used by banks to ensure capital levels are appropriate for their risk profile. It involves identifying, measuring, and monitoring all material risks, even those not fully captured under regulatory requirements. This internal framework ensures that the institution's capital planning is consistent with its risk appetite and management systems.

NODIA

8. (B) It should use value-at-risk modelling and stress testing, assessing concentration risk and illiquidity under stress.
Sophisticated banking institutions are expected to employ advanced methodologies for calculating market risk capital. This includes using value-at-risk models supplemented by rigorous stress testing to identify potential losses in extreme scenarios. Furthermore, the assessment must specifically address risks associated with portfolio concentration and the potential for asset illiquidity during periods of market stress to ensure comprehensive capital coverage.

9. (B) Duration gap analysis of off-balance sheet derivatives
Developing credit risk methodologies requires analyzing factors such as historical loss data, specific borrower attributes, and macroeconomic forecasts. These elements help quantify the likelihood of default and potential loss severity. However, duration gap analysis is primarily a tool used in interest rate risk management rather than credit risk assessment. Therefore, it is not a standard component for quantifying credit risk.

10. (C) The ICAAP sophistication should match the nature, scale, and complexity of a bank's business operations.
Proportionality in the Internal Capital Adequacy Assessment Process ensures that the complexity of a bank's risk management framework reflects its specific operational profile. Smaller, simpler institutions may use less complex methods, while large or internationally active banks must employ highly sophisticated systems. This approach prevents unnecessary regulatory burdens on smaller banks while ensuring larger institutions manage their risks appropriately.

11. (A) 2, 4, 1, 3
Regulatory guidelines for managing liquidity risk require banks to monitor mismatches across various time horizons. These buckets are organized chronologically to assess short-term funding needs. The standard sequence begins with the next day, followed by two to seven days, then eight to fourteen days, and finally fifteen to twenty-eight days. This progression allows for systematic monitoring of immediate and near-term liquidity.

12. (C) April 27, 2007
The Reserve Bank of India officially adopted the revised framework for capital adequacy, known as Basel II, on April 27, 2007. This implementation introduced more risk-sensitive capital requirements, focusing on credit, market, and operational risks. The adoption marked a significant step in aligning the Indian banking sector with international standards for risk management, capital measurement, and supervisory review processes.

13. (A) Ensure there is no separation between business lines and the risk function to streamline cross-departmental accountability.
Effective risk management frameworks necessitate a clear structural separation between business units and the risk control function. This independence prevents conflicts of interest and ensures that risk assessments remain objective and unbiased. Policies should also provide for the identification and mitigation of risks, escalation of limit breaches, and regular reviews to keep management strategies aligned with the bank's risk profile.

14. (C) Principle 3 states that supervisors should expect banks to operate above minimum ratios and hold excess capital.
Pillar 2 of the Basel framework emphasizes the role of supervisory oversight in ensuring bank stability. Principle 3 specifically mandates that supervisors should expect institutions to maintain capital levels exceeding the regulatory minimums. This requirement provides a cushion against risks not fully captured under Pillar 1 and ensures that banks possess sufficient resources to withstand unexpected financial stress or economic downturns.

15. (D) Any single exposure or group of exposures with the potential to produce losses large enough to threaten a bank's health or ability to maintain its core operations.
Concentration risk refers to the potential for significant losses resulting from a large exposure to a single counterparty, sector, or geographic region. Such exposures can jeopardize a bank's

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financial health if the underlying entity or industry faces distress. Managing this risk is vital for diversification and involves setting limits to ensure that no single group of exposures can compromise solvency.

16. (A) A supervisory review of a bank's internal capital assessment and its independent risk profile.
The Supervisory Review and Evaluation Process is a regulatory framework used by supervisors to assess a bank's internal capital adequacy assessment. It involves evaluating how well the bank identifies and manages its risks and whether the held capital is sufficient. This process ensures that the regulator and the bank agree on the risk profile and necessary capital buffers for stability.

17. (A) Risks from technological obsolescence
Capital planning utilizes stress testing to evaluate how adverse changes in the economic, regulatory, or earnings environment affect a bank's solvency. These tests provide insights into potential vulnerabilities and help management prepare contingency plans. While technological obsolescence is a valid operational concern, it is generally not a primary factor analyzed within the specific context of capital adequacy stress scenarios.

18. (C) 1.00% or more
Banking regulations require institutions to manage and mitigate country risk arising from cross-border exposures. When a bank's net funded exposure to a specific country reaches or exceeds one percent of its total assets, it must establish provisions. This threshold ensures that banks maintain financial reserves against potential losses caused by economic or political events impacting their international lending and investments.

19. (D) Shocks should be modeled for any currency where off-trading book items exceed 10% of total banking book volume.
Managing interest rate risk in the banking book involves regular analysis of potential shocks and their impact on profitability and economic value. However, the requirement to model shocks for specific currencies is usually triggered by a threshold of five percent. Accurate stress testing is essential for maintaining long-term solvency, as it identifies how fluctuations in interest rates could erode capital.

20. (A) Senior management is responsible for ensuring that ICAAP activities authorized by the board are implemented in a satisfactory manner.
Senior management plays a crucial role in executing the Internal Capital Adequacy Assessment Process approved by the board of directors. Their primary responsibility is to ensure that the risk management strategies and capital assessments are implemented effectively across the organization. This involves translating board-approved policies into operational procedures and maintaining oversight to ensure that the bank operates within its established risk limits.

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21. (C) Defining high-level risk appetite, setting limits based on that appetite, and assigning limits to business lines.
Establishing a robust risk management process begins with the formulation of a high-level risk appetite by the board. Once the overall willingness to take risk is defined, the bank sets specific internal limits to quantify these boundaries. Finally, these limits are assigned to various business lines and risk categories to ensure operational adherence to the institution's strategic risk objectives.

22. (B) Operational Risk
Under the Basel II framework, operational risk was explicitly introduced as a component for calculating minimum capital requirements under Pillar 1. This addition recognized that losses from internal processes, people, systems, or external events are significant. By requiring capital for operational risk, the framework ensures that banks are better prepared for non-financial failures that could threaten their overall stability and solvency.

23. (D) The bank's planned business structure and strategy, ensuring consistency between business and risk goals.
A bank's target risk structure should be intrinsically linked to its long-term business strategy and planned operational growth. By aligning risk targets with strategic goals,

the institution ensures that its risk-taking activities remain within manageable levels. This consistency allows the bank to allocate capital efficiently while supporting its business objectives and maintaining a stable profile during different market cycles.

24. (D) Counterparty settlement risk
Interest rate risk in the banking book arises from the impact of interest rate changes on assets and liabilities. It encompasses repricing risk, basis risk, yield curve risk, and option risk. These categories address mismatches in maturity, benchmark correlations, and embedded product features. Counterparty settlement risk, however, is a form of credit risk rather than a direct component of interest rate risk.

25. (B) It mandates a fixed, identical capital buffer for all banks regardless of their individual risk profiles.
The Internal Capital Adequacy Assessment Process is designed to be bank-specific, reflecting each institution's unique risk profile. It does not mandate a fixed, uniform capital buffer for all banks. Instead, it covers risks not fully addressed in Pillar 1 and accounts for external environmental factors. This personalized approach ensures that capital levels are truly commensurate with the specific risks faced.

26. (D) Risk where credit risk mitigation techniques become ineffective for reasons other than the default of the guarantor.
Residual credit risk arises when techniques used to mitigate credit exposure, such as collateral or guarantees, prove less effective than expected. This can occur for reasons other than the default of the guarantor, such as legal flaws or valuation errors. Banks must account for this risk because over-reliance on mitigation can lead to insufficient capital if those protections fail during stress.

27. (A) It has to do with the competency of the staff and is inherently difficult to measure.
Operational risk is inherently complex because it stems from human behavior, internal process failures, and system inadequacies. Unlike market or credit risks, which often rely on observable financial data, operational events are idiosyncratic and difficult to quantify precisely. The subjective nature of staff competency and the unpredictability of external events make developing accurate, predictive models for operational losses particularly challenging.

28. (A) It helps protect banks from insolvency, promoting the overall safety and soundness of the banking system.
Capital serves as a vital financial cushion that absorbs unexpected losses, thereby protecting a bank from insolvency. By maintaining adequate capital levels, institutions contribute to the overall stability and soundness of the global banking system. This protection ensures that banks can continue to operate and meet their obligations even during periods of severe economic distress or significant internal operational failures.

29. (C) Operational Risk
Pillar II risks are those not fully captured or entirely ignored by the Pillar 1 framework. Examples include concentration risk, interest rate risk in the banking book, and reputation risk. Operational risk, however, is explicitly accounted for under the Pillar 1 minimum capital requirements. Therefore, while it is a major risk, it is categorized as a Pillar 1 component.

30. (D) The ICAAP should be prepared at every tier for each banking entity and at the level of the consolidated bank.
To ensure comprehensive risk oversight, the Internal Capital Adequacy Assessment Process should be implemented at multiple levels within a banking group. This includes performing assessments for each individual banking entity (solo level) as well as at the consolidated group level. This tiered approach ensures that capital adequacy is monitored across the entire organization, capturing risks at both local and global scales.

31. (C) Sovereign risk - Derives from the insolvency of the country in which the institution has an exposure.
Sovereign risk specifically relates to the potential for a foreign government to default on its debt obligations or become insolvent. This is distinct from transfer risk, where a debtor has the local

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currency but cannot convert it, or collective debtor risk, which affects broad groups of borrowers. Accurate classification of these risks is essential for appropriate provisioning and international credit management.

32. (D) (I), (II), (III), (IV), and (V)
A robust, firm-wide risk management system must integrate several critical components. This includes active oversight by the board and senior management, clear policies and limits, and comprehensive risk identification and reporting. Furthermore, effective management information systems and strong internal controls are essential to monitor and mitigate risks. Together, these elements ensure that the institution maintains a stable and well-controlled risk profile.

33. (A) P-4, Q-1, R-2, S-3
Repricing risk stems from timing differences in maturity and rate changes, while basis risk involves imperfect correlations between different interest rate benchmarks. Yield curve risk arises from changes in the shape or slope of the yield curve, affecting asset and liability values. Finally, option risk is associated with the rights inherent in banking products, such as early loan prepayments or withdrawals.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Stress testing is an essential tool for identifying concentration risks that may not be apparent during normal business operations. In stable environments, these risks often remain hidden as diverse portfolios perform predictably. However, severe economic shocks can cause previously uncorrelated exposures to fail simultaneously. Therefore, testing extreme scenarios is critical for uncovering hidden vulnerabilities and ensuring a bank's long-term resilience.

35. (A) Both Statement (I) and Statement (II) are true.
Many banks globally utilize the Standardized Approach for calculating credit risk capital, relying on external ratings and regulatory risk weights. Under this approach, institutions must ensure that the classification of their exposures is thoroughly documented and supported by regulatory guidelines. This ensures consistency and transparency in capital reporting, allowing supervisors to evaluate whether the bank's risk-weighted assets accurately reflect its exposure.

36. (A) No, a liquidity buffer does not substitute for careful stress preparation or management of funding gaps.
While establishing a liquidity buffer of high-quality assets is crucial for surviving stress scenarios, it does not replace the need for active daily management. Banks must continue to monitor and manage their funding gaps and resources to ensure operational efficiency. The buffer is a secondary defense for emergencies, whereas daily cash flow management remains the primary process for maintaining liquidity.

37. (A) P-3, Q-4, R-1, S-2
Principle 1 requires banks to have an internal capital assessment process, while Principle 2 tasks supervisors with reviewing these assessments. Principle 3 states that supervisors should expect banks to hold capital above minimum requirements. Principle 4 empowers supervisors to intervene early if capital levels fall too low. Together, these principles form the foundation of the Supervisory Review Process under the Basel framework.

38. (D) (I), (II), (III), and (IV)
The board's evaluation of the Internal Capital Adequacy Assessment Process must be comprehensive. This includes reviewing the appropriateness of the process relative to the bank's complexity, identifying risk concentrations, and ensuring data accuracy. Furthermore, the board must validate the reasonableness of the stress scenarios used. This high-level oversight ensures that the ICAAP remains a reliable tool for strategic capital planning and risk profile.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
An effective Internal Capital Adequacy Assessment Process must be forward-looking to account for future strategic shifts and macroeconomic changes. By anticipating these developments, ICAAP ensures that the bank's capital levels support sustainable, risk-adjusted

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growth rather than acting as a rigid constraint. This integration between capital planning and business strategy allows the institution to pursue new opportunities while maintaining a sound financial position.

40. (D) $<$ 1000 - Moderate Risk
The Herfindahl-Hirschman Index is a standard tool used to measure market or portfolio concentration. According to common risk classifications, an HHI value of less than 1000 indicates a low level of concentration, which corresponds to low risk. Labeling a score below 1000 as moderate risk is incorrect, as moderate concentration is typically defined by scores between 1000 and 1800.

41. (B) It will be treated as excessive, and the bank would normally be required by the regulator to hold additional capital against IRRBB.
Under regulatory standards, a drop in the Market Value of Equity exceeding twenty percent following a two hundred basis point interest rate shock is considered excessive. In such cases, the supervisor will likely require the bank to hold additional capital during the Supervisory Review and Evaluation Process. This ensures the institution has a sufficient buffer to mitigate high levels of interest rate risk.

42. (A) P-3, Q-2, R-1, S-4
Provisioning requirements for country risk are determined by the ECGC classification. Category A1 requires a minimal provision of 0.25%, while Category B1 is set at 5%. More significant risks, such as Category B2, require a 15% provision, and Category C1 mandates 25%. These tiered percentages ensure that banks maintain adequate reserves proportional to the perceived risk level of their international exposures.

43. (D) (I), (II), (III), and (IV)
Independent reviews are essential for maintaining the integrity of a bank's risk management processes. These audits should confirm the accuracy of data inputs, the reasonableness of the overall processes, and the effectiveness of stress testing. Additionally, the reviews must ensure that concentration risks are identified promptly. Such oversight provides assurance that the capital assessment framework remains robust, reliable, and compliant with regulatory standards.

44. (B) Only (I) and (III)
Reputation risk involves the negative shift in stakeholder expectations, which can lead to financial losses and a decline in customer base. It is often described as a derivative risk because it typically stems from other events, such as credit failures or operational lapses. Unlike gradual changes, reputation damage can occur rapidly and have an immediate, severe impact on a bank's franchise.

45. (C) It breaches the prescribed limit, as the net cumulative negative mismatch for this bucket should not exceed -20%.
Standard Asset Liability Management guidelines set specific limits on cumulative negative mismatches for short-term time buckets. For the eight-to-fourteen-day period, the net cumulative negative mismatch is generally restricted to a maximum of twenty percent of cumulative cash outflows. A calculated mismatch of twenty-four percent represents a breach of these prescribed prudential limits, requiring immediate attention and corrective action from management.

46. (B) P-3, Q-4, R-2, S-1
Pillar 1 covers credit, market, and operational risks through minimum capital requirements. Risks not adequately covered by Pillar 1 include residual and securitization risks. Concentration and liquidity risks are categorized as Pillar II risks, which are assessed within the ICAAP framework. Other risks, such as model risk, also require identification and management to ensure the bank's overall capital adequacy remains sufficient.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Regulators expect a bank's Internal Capital Adequacy Assessment Process to be proportional to its business complexity. The principle of proportionality allows for a tiered approach, where the sophistication of risk measurement matches the scale of operations. This ensures that complex universal banks use

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advanced models while simpler institutions employ straightforward methods. This alignment prevents over-complexity for smaller banks while maintaining stability for larger institutions.

48. (B) Chief Risk Officer - Reports directly to the heads of the individual business lines to facilitate faster credit approvals.
The role of the Chief Risk Officer is to provide independent oversight of the institution's risk profile. Reporting directly to business line heads would compromise this independence and create conflicts of interest, especially regarding credit approvals. Instead, the risk function should report to the CEO and the board. This structure ensures that risk management remains objective and is not sidelined by profit-driven units.

49. (D) (I), (II), (III), (IV), and (V)
Measuring interest rate risk in the banking book requires evaluating both the earnings perspective and the economic value of equity. Banks use gap analysis for earnings and apply a two hundred basis point shock to assess capital impact. A drop in market value exceeding twenty percent is considered excessive. Such excessive risk typically leads regulators to mandate additional capital buffers through the SREP.

50. (D) (I), (II), and (III)
When assessing risks in trading activities, banks must look beyond simple market price movements. They must consider instrument illiquidity and the challenges of concentrated or one-way positions, which can be difficult to exit during stress. Additionally, the impact of non-linear positions and shifting correlations must be evaluated. These factors are crucial for accurately determining potential losses in volatile or distressed market conditions.

51. (D) A notional shock of 200 basis points.
To assess interest rate risk in the banking book, regulatory frameworks prescribe applying a standard notional shock to the yield curve. A two hundred basis point shock is the benchmark used to calculate the resulting impact on the bank's Market Value of Equity. This standardized stress test allows for a consistent comparison of interest rate sensitivity across different institutions and identifies those with excessive exposures.

52. (D) Shock 1 - Parallel upward/downward shift of yield curve (200 basis points).
The Basel Committee recommends standardized interest rate shocks to evaluate a bank's sensitivity to rate movements. Shock 1 specifically refers to a parallel upward or downward shift of the yield curve by two hundred basis points. This test is a fundamental part of the Interest Rate Risk in the Banking Book assessment, helping supervisors determine if the institution's capital is sufficient.

53. (C) Statement (I) is true, but Statement (II) is false.
Capital allocation is a strategic process used to distribute capital across various organizational units based on their risk exposure. Linking this allocation to performance measurement and pricing is actually a sign of advanced risk management, not a mere regulatory formality. It ensures that business decisions are risk-adjusted, encouraging units to use capital efficiently and align their activities with the bank's overall appetite.

54. (C) Assertion (A) is true, but Reason (R) is false.
Banks are required to provide their board of directors with a periodic written record of the ICAAP outcome. This ensures that the board remains informed about the institution's risk profile and capital adequacy. The claim that ICAAP is a one-time, static assessment is incorrect; it is a dynamic, ongoing process that must be updated regularly to reflect changes in the environment.

55. (D) (I), (II), (III), and (IV)
A bank's management information system must be highly capable to support an effective ICAAP. It should identify concentrations, adapt to changing risk assumptions, and generate forward-looking scenarios. Crucially, the system must capture and report limit breaches to senior management immediately. These features ensure that leadership has the necessary data to make informed decisions

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(D) The medium shock for parallel upward/ downward shift of the yield curve is 500 bps.

Oct/Nov 2022

14. Which of the following statements correctly describes a feature of a sound stress testing framework?

(A) The stress testing framework should be standardized across all banks regardless of the complexity of their business activities.

(B) Banks must restrict their stress testing exclusively to market risks, as credit risks are inherently non-volatile and stable.

(C) Assumptions should be well documented, reviewed periodically, and available for verification by supervisors.

(D) Stress testing frameworks require no formal Board approval provided they are managed directly by the Chief Risk Officer.

May/June 2018

15. What is the most appropriate way for a bank's senior management to interpret the results of stress tests?

(A) Exact predictions of future losses that must trigger immediate liquidation of all risky assets.

(B) Indicators of the likelihood of stressful events occurring, providing a precise probability distribution.

(C) Absolute limits that require no further qualitative judgment or internal management adjustment.

(D) Indicative information that helps in understanding risk shapes and improving overall resilience.

Oct/Nov 2016

16. What is the precise definition of "sensitivity analysis" in stress testing?

(A) An illustration of how an institution's position changes when a single risk factor is modified while others remain constant.

(B) An analysis that assumes the simultaneous change of several risk factors and quantifies their combined impact on the portfolio.

(C) An analysis that identifies a significant negative outcome and then determines the specific causes that could lead to it.

(D) An evaluation of cash-flow patterns of assets and liabilities under a general market crisis scenario to assess liquidity.

May/June 2014

17. The objectives of stress testing frameworks perform multiple dual roles. Which of the following is NOT one of those roles?

(A) Generating guaranteed predictive forecasts to eliminate the probability of future market losses.

(B) Serving as a diagnostic tool for improving a bank's understanding of its specific risk profile.

(C) Supplementing internal capital models where historical data limits overall predictive power.

(D) Introducing a forward-looking element in the internal capital adequacy assessment process.

Oct/Nov 2007

18. What constitutes a "small business" for the purpose of liquidity risk stress tests?

(A) An entity where the total average annual turnover is less than ₹ 25 crore.

(B) An entity where the total average annual turnover is less than ₹ 50 crore.

(C) An entity where the total average annual turnover is less than ₹ 100 crore.

(D) An entity where the total average annual turnover is less than ₹ 500 crore.

May/June 2025

19. Which of the following statements incorrectly identifies a discretionary corrective action under the Prompt Corrective Action (PCA) framework?

(A) Restrictions on directors' or management compensation is a Governance related action.

(B) Restriction/reduction of outsourcing activities is an Operations related action.

(C) Review of specialized training needs of existing staff is an HR related action.

(D) Detailed Board level review of capital planning is a Strategy related action.

Oct/Nov 2019

20. Which statement accurately reflects the concept of reverse stress testing?

(A) It identifies possible combinations of events that threaten the viability of the

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comparison helps management identify areas where the bank is over-concentrated, such as in market risk, and highlights where corrective actions are needed. It serves as a practical roadmap for evolving the portfolio toward a more balanced and strategically aligned risk structure over time.

65. (B) Yes, because the bank's net funded exposure is 1% or more of its total assets.
Global Bank's net funded exposure of ₹1,500 crores in Country X represents 1.5% of its ₹1,00,000 crore total asset base. Since this exposure exceeds the regulatory threshold of one percent, the bank is required to make provisions for country risk. This mandatory requirement ensures that banks maintain a financial cushion against potential losses stemming from their significant cross-border lending and investment activities.

66. (D) Yes, because the aggregate exposure exceeds 10% of the bank's Tier 1 capital.
A 'large borrower' is generally defined based on the size of the bank's aggregate exposure to a single client relative to its capital. In this case, an exposure of ₹600 crores exceeds ten percent of the bank's ₹5,000 crore Tier 1 capital. Therefore, ABC Enterprises qualifies as a large borrower. This classification is used to monitor and manage concentration risk within the banking portfolio.

67. (D) No, the risk function should be independent and report directly to the CEO/Managing Director and the board.
For a risk management framework to be effective, the risk function must remain independent of the business lines it monitors. The Chief Risk Officer should report directly to the CEO or Managing Director and the board, rather than to a business head like the lending division. This independence ensures that risk assessments are not compromised by the bank's pursuit of lending.

68. (A) 20.00%
Under the standardized framework for country risk, provisioning percentages are tied to the ECGC's risk classification. For a country classified as 'B2' (High), banks are required to maintain a provision of fifteen percent on their net funded exposure. This tiered system ensures that capital reserves are proportional to the risk levels associated with international lending, providing a buffer against sovereign.

69. (B) Moderate concentration (Moderate Risk)
An HHI value of 1450 falls within the standard range of 1000 to 1800, which is classified as moderate concentration. In credit risk management, this indicates a moderate level of risk associated with sectoral or counterparty exposure. Banks with this score should monitor their portfolios to ensure that concentration does not increase further, which could lead to high-risk levels and additional capital requirements.

70. (B) Using ICAAP to allocate capital to units and letting it play a role in credit decisions and product pricing.
Integrating ICAAP into a bank's management culture is best demonstrated by using its results in core business processes. This includes utilizing capital assessment data for internal capital allocation, credit decision-making, and product pricing. When risk-based capital considerations influence daily operations and strategic planning, the ICAAP becomes a vital tool for steering the bank toward risk-adjusted profitability rather than being a mere regulatory exercise.

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and maintain the bank's risk profile within established limits.

56. (A) P-3, Q-1, R-2, S-4
The Herfindahl-Hirschman Index categorizes concentration levels based on numerical scores. An HHI below 1000 reflects low concentration, while a score between 1000 and 1800 indicates moderate concentration. Values exceeding 1800 represent high concentration. The index is calculated by summing the squares of individual market shares. These classifications help banks and regulators identify portfolios that may be overly exposed to specific sectors.

57. (A) A one-month survival period
Standard advisory guidelines for liquidity risk management recommend that banks conduct stress tests based on a one-month survival period. This timeframe allows the institution to evaluate whether it has sufficient high-quality liquid assets to withstand a period of severe stress. By analyzing this thirty-day window, the bank can identify potential funding gaps and ensure its contingency plans are adequate for short-term.

58. (A) Both Statement (I) and Statement (II) are true.
A strong internal control structure is vital for an effective capital assessment process. This includes treating controls as a second line of defense that operates on an integrated basis across the bank. Furthermore, involving independent reviews and internal or external audits ensures that the assessment remains objective and accurate. These layers of oversight help identify weaknesses and ensure that the process functions as intended.

59. (D) (I), (II), (III), (IV), and (V)
Ensuring capital adequacy at all times requires a comprehensive planning process. Banks must consider current requirements, planned consumption, and target capital levels aligned with their strategy. Additionally, they must identify internal and external management resources and other means, such as budgeting, to maintain stability. This multifaceted approach ensures that the institution can support its growth while remaining resilient against various financial risks.

60. (A) Only (I) and (II)
Liquidity risk is measured using both stock and flow approaches, such as the traditional gap analysis. Regulatory limits specify that net cumulative negative mismatches in the eight-to-fourteen-day bucket should not exceed twenty percent of cumulative cash outflows. However, the limit for the fifteen-to-twenty-eight-day bucket is typically set at a different level than thirty-five percent, which makes the third statement technically incorrect.

61. (C) Sovereign risk
When a foreign government becomes insolvent and defaults on its debt, the resulting financial loss for a bank is classified as sovereign risk. This specific type of country risk reflects the danger of a central authority failing to meet its payment obligations. It is different from transfer risk, which involves currency conversion issues, or collective debtor risk, which applies to private sector defaults.

62. (A) 800% of its Tier 1 capital
To mitigate concentration risk, banks are advised to limit their total exposure to all 'large borrowers' as a group. Prudent practices suggest that this aggregate exposure should not exceed eight hundred percent of the bank's Tier 1 capital. This ceiling ensures that the institution's overall solvency is not overly dependent on a few significant clients, promoting better diversification and systemic stability.

63. (C) Option risk
Option risk arises when a bank's products allow customers to change the timing or amount of cash flows, such as prepaying a loan or withdrawing a deposit early. In this scenario, borrowers exercising their right to prepay fixed-rate loans during a period of falling interest rates illustrates this risk. These embedded options can significantly alter the bank's expected interest income and its economic value.

64. (C) It highlights potential needs for action and provides a framework for development toward a target risk structure.
Analyzing the bank's actual risk structure provides a snapshot of current exposures compared to the target risk profile. This

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qualitative manner.
(C) It is entirely exempt from considering any interactions between risks and should only focus on single risk factors in isolation.
(D) It must outsource its stress testing completely to external auditors using heterodox algorithms.

May/June 2012

7. Which of the following best defines "stress testing" in the context of risk management?
(A) The continuous monitoring of day-to-day market variable fluctuations and volatility to calculate the total value-at-risk.
(B) The evaluation of a bank's financial position under a severe but plausible scenario to assist in internal decision making.
(C) The process of modifying multiple risk factors under expected normal market conditions to estimate the overall potential profit.
(D) The statistical measurement of risks based exclusively on historical data and standard distribution assumptions for projections.

Oct/Nov 2014

8. Which of the following statements regarding the criteria for Prompt Corrective Action (PCA) is correct?
(A) The indicators tracked for Asset Quality and Leverage are Gross NPA Ratio and Tier II Capital Ratio respectively.
(B) Breach of any risk threshold in Capital, Asset Quality, or Leverage may result in the invocation of PCA.
(C) A bank is placed under PCA based solely on unaudited quarterly financial results.
(D) A regulatory minimum Tier 1 Leverage Ratio breach of more than 100 bps places the bank in Risk Threshold 2.

May/June 2019

9. When a bank breaches Risk Threshold 1 under the Prompt Corrective Action (PCA) framework, the mandatory actions include all of the following EXCEPT:
(A) Restriction on dividend distribution.
(B) Restriction on branch expansion.
(C) Restriction on remittance of profits.
(D) Promoters/Owners to bring in capital.

Oct/Nov 2006

10. How does stress testing fundamentally complement the internal capital adequacy assessment process (ICAAP)?
(A) By replacing internal capital models when historical data is abundant and provides high predictive accuracy.
(B) By strictly relying on statistical risk measures derived from normal market conditions to determine capital.
(C) By introducing forward-looking elements that identify severe events or market changes impacting the bank's stability.
(D) By determining the exact likelihood of occurrence of seemingly impossible financial events in the global market.

May/June 2021

11. Identify the correct sequence of the net NPA increase applied as shocks (from Baseline to Medium to Severe) under the Credit Risk single factor stress test for "Increase in NPAs":
I 150 percent
II 50 percent
III 100 percent
(A) (I), (II), (III)
(B) (II), (I), (III)
(C) (II), (III), (I)
(D) (III), (II), (I)

Oct/Nov 2010

12. For how long must a bank preserve the documentation of the stress tests undertaken, the underlying assumptions, the results, and the outcomes?
(A) At least for three years
(B) At least for five years
(C) At least for seven years
(D) At least for ten years

May/June 2005

13. Regarding the single factor stress tests for Market Risk and Interest Rate Risk, which statement is incorrect?
(A) The baseline shock for parallel upward/ downward shift of the yield curve is 200 bps.
(B) The steepening of the yield curve involves 100 bps linearly spread between 15-day and over 25-year maturities.
(C) The severe shock for decline in equity prices across the board is 60 percent.

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commenced reverse stress tests were expected to start doing so from April 1, 2015.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (IV)
(B) (I), (II), and (III)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

May/June 2011

39. The following question consists of two statements, one labeled as "Assertion (A)" and the other as "Reason (R)". Examine these two statements carefully and select the correct answer using the codes given below.

Assertion (A): The simultaneous application of different stress testing methodologies is considered desirable for an institution's risk assessment.

Reason (R): Different stress testing techniques represent different ways for assessing an institution's risks, with each capturing different aspects of exposures.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2020

40. Which of the following pairs of "Liquidity Outflow Parameter" and its "Medium run-off factor" is INCORRECTLY matched?

(A) Partial loss of stable wholesale deposits from large entities : 10%
(B) Partial loss of unstable retail deposits from natural persons : 20%
(C) Unscheduled draws on retail and small business customers : 20%
(D) Other level 2B asset classes in the trading portfolio : 70%

May/June 2022

41. Zeta Bank's minimum regulatory prescription for Capital to Risk Assets Ratio plus applicable Capital Conservation Buffer is 10.5%. Its current CRAR falls to 7.0%. Based on the Prompt Corrective Action (PCA) risk thresholds, under which category does this shortfall of 350 bps place the bank?

(A) Risk Threshold 1
(B) Risk Threshold 2
(C) Risk Threshold 3
(D) Normal Operations

Oct/Nov 2023

42. Match the Prompt Corrective Action (PCA) Risk Threshold in List I with its corresponding Leverage Ratio indicator in List II:

List I: (Risk Threshold)
P. Risk Threshold 1
Q. Risk Threshold 2
R. Risk Threshold 3
S. Normal Operations (No PCA)

List II: (Leverage Ratio Indicator)
1. More than 50 bps but not exceeding 100 bps below the regulatory minimum
2. Compliant with Regulatory minimum Tier 1 Leverage Ratio
3. More than 100 bps below the regulatory minimum
4. Up to 50 bps below the regulatory minimum

(A) P-4, Q-1, R-3, S-2
(B) P-1, Q-2, R-4, S-3
(C) P-4, Q-3, R-1, S-2
(D) P-3, Q-4, R-2, S-1

Oct/Nov 2021

43. Consider the following statements regarding remedial actions when stress tolerance levels are breached:

I Reduction of risk limits.
II Enhancing collateral requirements and seeking higher level of risk mitigants.
III Amending pricing policies to reflect previously unidentified risks.
IV Augmenting the capital levels to enhance the buffer.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (IV)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), (III), and (IV)

institution's business model.
(B) It applies historical scenarios to reverse the calculated risk weights to meet regulatory capital requirements.
(C) It is primarily used to identify manageable impacts in regular daily stress testing of market risk variables.
(D) It assumes a positive future outcome and back-tests variables to ensure consistent and high profitability levels.

May/June 2009

21. Identify the correct chronological sequence of the stress testing process:
I Apply shocks to the portfolio
II Identify potential movements and market variables to stress
III Revalue the portfolios to see the effect on Profit and Loss
IV Decide upon the magnitude of stress and time frame
(A) (II), (I), (IV), (III)
(B) (II), (IV), (I), (III)
(C) (IV), (II), (I), (III)
(D) (I), (II), (IV), (III)

Oct/Nov 2011

22. Under the Prompt Corrective Action (PCA) framework, what is the defined threshold for "Risk Threshold 1" regarding the Net Non-Performing Advances (NNPA) ratio?
(A) $\geq$ 6.0% but $<$ 9.0%
(B) $\geq$ 9.0% but $<$ 12.0%
(C) $\geq$ 12.0%
(D) $\geq$ 3.0% but $<$ 6.0%

May/June 2010

23. Which conceptual characteristic distinguishes an institution-specific crisis scenario from a general market crisis scenario?
(A) An institution-specific scenario involves severe contraction in the availability of secured and unsecured funding sources across the entire market.
(B) An institution-specific scenario leads to substantial discounts needed to sell repo assets due to a flight to quality among market participants.
(C) An institution-specific scenario is triggered by severe operational disruptions affecting national payment systems and settlement infrastructures.
(D) An institution-specific scenario assumes the bank's liabilities cannot be rolled over due to perceived problems affecting public confidence in the bank.

Oct/Nov 2024

24. Level 2B assets for liquidity inflow calculation include all of the following EXCEPT:
(A) Securitised instruments including Residential Mortgage Backed Securities (RMBS).
(B) Corporate bonds with a credit rating between A+ and BBB- in the open market.
(C) Equity shares and commercial paper issued by non-financial sector entities.
(D) Marketable non-financial sector corporate bonds rated AA- or better.

May/June 2017

25. Which of the following statements regarding the stress testing process is incorrect?
(A) The process involves identifying potential movements, deciding assumptions, and applying shocks to the portfolio.
(B) A single universally accepted methodology for stress testing exists that all institutions must adopt.
(C) Revaluing the portfolios allows for observing the effect of a market movement on the profit and loss.
(D) The simultaneous application of different heterodox methodologies is desirable for risk assessment.

Oct/Nov 2005

26. In the context of liquidity risk stress tests, how are "stable deposits" defined?
(A) Deposits placed in a bank by a natural person with no other banking relationship or additional financial products.
(B) Unsecured wholesale funding from non-natural persons including sole proprietorships and legal partnerships in the market.
(C) All retail deposits that are not subject to withdrawal within a minimum stress period of thirty calendar days.
(D) Insured deposits in transactional accounts where salaries are automatically credited or payments are paid out from.

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May/June 2020

27. When a bank is incorporating a combined scenario (institution-specific and general market crisis) into its stress tests, what is the best approach to estimate the impact?

(A) Modulating the severity of assumptions based on how the different stress circumstances interact.

(B) Adopting an "additive approach" by summing up the potential impacts of the individual scenarios.

(C) Applying only general market crisis assumptions, as they naturally supersede institution-specific factors.

(D) Reducing the minimum stress period to five business days to account for potential systemic intervention.

Oct/Nov 2015

28. What is the primary conceptual drawback of using sensitivity analyses instead of scenario analyses?

(A) It fails to reflect actual exposures because real-life risk factors impact the portfolio in combination rather than stand-alone.

(B) The magnitude of potential losses for a specific factor is difficult to determine with high precision or accuracy.

(C) It requires complex modeling of interrelations between multiple risk factors to be considered valid and reliable.

(D) It demands significant computational power to simulate forward-looking macroeconomic conditions and variables.

May/June 2013

29. All of the following are characteristics of a retail bank's institution-specific crisis scenario, EXCEPT:

(A) Significant daily run-off rates for deposits.

(B) No new unsecured or secured funding obtainable from the market.

(C) Interbank deposits being repaid before maturity.

(D) Forced sale of marketable securities at discounted prices.

Oct/Nov 2021

30. Which statement correctly represents the guidelines on liquidity risk stress tests regarding unscheduled draws on committed facilities?

(A) The baseline run-off factor for credit facilities to banks subject to prudential supervision is 10%.

(B) The severe run-off factor for retail and small business customers is 40%.

(C) The baseline run-off factor for credit and liquidity facilities to 100% other legal entities is 50%.

(D) The medium run-off factor for credit facilities to non-financial corporates is 20%.

May/June 2024

31. Which of the following pairs of "Liquidity Inflow Instrument (Securities held under HFT)" and its "Baseline Haircut" is correctly matched?

(A) Corporate bond with credit rating of AA- or higher : 30%

(B) Securitised instruments including Residential MBMS : 50%

(C) Corporate bond with rating between A+ and BBB- : 50%

(D) Equity shares listed on major stock exchanges : 100%

Oct/Nov 2008

32. Consider the following statements regarding the criteria and actions for Prompt Corrective Action (PCA):

I Capital, Asset Quality, and Leverage are the key areas for monitoring in the revised framework.

II The indicator tracked for Capital is the CRAR / Common Equity Tier 1 Ratio.

III The PCA framework does not apply to foreign banks operating through branches.

IV A bank can exit PCA if no breaches in risk thresholds are observed as per four continuous quarterly financial statements.

V Depositors need to be guaranteed almost uninterrupted access to their funds if bank runs are to be avoided.

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), (IV)
(B) (I), (II), (IV), (V)
(C) (I), (III), (IV), (V)
(D) (II), (III), (IV), (V)

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May/June 2006

33. Match the Liquidity Risk Outflow parameter in List I with its Severe run-off factor in List II:

List I: (Outflow Parameter)

P. Partial loss of stable retail deposits

Q. Unscheduled draws on credit facilities to banks subject to prudential supervision

R. Partial loss of unstable wholesale deposits

S. Partial loss of secured short term financing (Non-financial corporate bonds)

List II: (Severe Run-off Factor)

1. 60%
2. 20%
3. 100%
4. 40%

(A) P-2, Q-3, R-4, S-1
(B) P-4, Q-1, R-2, S-3
(C) P-2, Q-1, R-3, S-4
(D) P-3, Q-4, R-1, S-2

Oct/Nov 2017

34. The following question consists of two statements, one labeled as "Assertion (A)" and the other as "Reason (R)". Examine these two statements carefully and select the correct answer using the codes given below.

Assertion (A): The Prompt Corrective Action (PCA) framework applies only to domestic commercial banks and excludes foreign banks operating in certain jurisdictions.

Reason (R): Acting on cross-border banks can be more difficult as the tools and responsibilities are primarily national.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2008

35. Consider the following statements regarding Reverse Stress Testing:

I It consists of identifying a scenario that threatens the viability of the institution's business model.

II A key objective is to induce a false sense of security by confirming that manageable impacts cover all possible extreme events.

Which of the above statement(s) is/are correct?

(A) Both (I) and (II) are correct.
(B) Both (I) and (II) are incorrect.
(C) Only (I) is correct.
(D) Only (II) is correct.

Oct/Nov 2013

36. Sigma Bank, a retail institution, is running its liquidity risk stress test. It has total stable retail deposits of ₹ 5,000 crore and unstable retail deposits of ₹ 2,000 crore. Under the "Baseline" outflow scenario, what is the combined expected run-off amount from these two categories?

(A) ₹ 450 crore
(B) ₹ 650 crore
(C) ₹ 900 crore
(D) ₹ 1,800 crore

May/June 2015

37. Match the Risk categories in List I with their respective stress scenarios in List II:

List I: (Risk Categories)

P. Credit Risk

Q. Interest Rate Risk

R. Liquidity Risk

S. Equity Price Risk

List II: (Stress Scenarios)

1. Significant daily run-off rates for deposits
2. Decline across the board by 40 percent (Baseline)
3. Slippage of Restructured Standard Assets
4. An Inversion of the yield curve

(A) P-3, Q-4, R-1, S-2
(B) P-1, Q-2, R-3, S-4
(C) P-4, Q-1, R-2, S-3
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2012

38. Consider the following statements regarding the classification of banks for stress testing:

I Group A banks have Total Risk Weighted Assets of more than ₹ 2000 billion.

II Group B banks are required to conduct multifactor sensitivity analysis and simple scenario analyses.

III Group C banks have Total Risk Weighted Assets less than ₹ 500 billion.

IV Group A banks which have not yet

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CHAPTER 29

Stress Testing and PCA Framework

May/June 2016

1. In the single factor stress tests for Foreign Exchange Risk, what is the specified "Severe" shock for the depreciation of the local currency?
(A) 15% depreciation in 30 days
(B) 20% depreciation in 30 days
(C) 25% depreciation in 30 days
(D) 30% depreciation in 30 days

Oct/Nov 2009

2. Which statement incorrectly describes the classification of banks for the purpose of stress testing?
(A) Group A banks have Total Risk Weighted Assets exceeding a valuation of more than ₹ 2000 billion.
(B) Group B banks have Total Risk Weighted Assets calculated between ₹ 500 billion and ₹ 2000 billion.
(C) Group C banks are expected to carry out complex macro scenario exercises and regular reverse stress testing.
(D) Group C banks must conduct simple sensitivity analyses of the specific risk types to which they are exposed.

May/June 2023

3. How is "reverse stress testing" defined?
(A) Assessing the impact of hypothetical historical scenarios on the current trading book and overall capital requirements.
(B) Determining the normal operating environment required to prevent disaster myopia and ensure long-term stability.
(C) Identifying a severe negative outcome and then identifying the causes and consequences that could lead to such an event.
(D) Reversing the stress tolerance limits to match the institution's existing risk appetite and strategic objectives.

Oct/Nov 2018

4. What is the most appropriate lesson to be drawn from the concept of the "Black Swan" event for a bank's risk management strategy?
(A) Statistical models based on historical white swan data are infallible for future predictions.
(B) Black Swan events only affect equity markets and have a 0 percent chance of impacting debt portfolios.
(C) Seemingly improbable events are more likely than believed, necessitating forward-looking stress testing.
(D) Banks should exclusively prepare for events that have occurred within the previous five year cycle.

May/June 2007

5. What is the foundational objective of the Prompt Corrective Action (PCA) framework?
(A) To initiate the corporate insolvency resolution process for failing banks to protect the broader economy.
(B) To start corrective action early, before capital triggers are reached, based on risk assessment and market signals.
(C) To provide emergency liquidity assistance from the regulator during a severe market-wide liquidity squeeze.
(D) To eliminate the need for full insurance on most deposits by preventing any possibility of systemic bank runs.

Oct/Nov 2025

6. For a Group C bank attempting to evaluate interactions between intra- or inter-risk concentrations, what is the most appropriate expectation given its classification?
(A) It must perform complex firm-wide scenario based quantitative stress tests identical to Group A banks.
(B) It should attempt to qualitatively analyse the interactions among risk types and at least address firm-wide stress testing in a

NODIA

May/June 2018

44. Consider the following statements regarding the annual reviews of a stress testing framework:

I Adequacy of the documentation for various elements of the stress testing framework.

II Integration of the stress testing framework in the day-to-day risk management processes.

III Integrity of MIS and data feeding into the stress tests.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2016

45. Delta Bank holds a large unhedged foreign currency portfolio. In evaluating foreign exchange risk under Shock 1 (Depreciation of local currency), the risk committee requires a capital adequacy assessment under the "Severe" shock scenario. What parameter must they apply?

(A) 15 percent depreciation in 30 days
(B) 20 percent depreciation in 30 days
(C) 25 percent depreciation in 30 days
(D) 30 percent depreciation in 30 days

May/June 2014

46. Match the Credit Risk Shocks in List I with their descriptions in List II:

List I: (Credit Risk Shocks)

P. Shock 2
Q. Shock 5
R. Shock 6
S. Shock 8

List II: (Descriptions)

1. Downgrade in counter-party rating
2. Group Default by largest group borrower
3. Increase in NPA in Top Five Industries
4. Depletion in collateral

(A) P-3, Q-4, R-1, S-2
(B) P-4, Q-1, R-2, S-3
(C) P-1, Q-3, R-4, S-2
(D) P-3, Q-2, R-1, S-4

Oct/Nov 2007

47. The following question consists of two statements, one labeled as "Assertion (A)" and the other as "Reason (R)". Examine these two statements carefully and select the correct answer using the codes given below.

Assertion (A): Stress tests explicitly indicate the likelihood of occurrence of stressful events.

Reason (R): Stress testing is influenced by the judgment and experience of the people who design the tests.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

NODIA

May/June 2025

48. Which of the following pairs of "Prompt Corrective Action (PCA) Risk Threshold" and its "Mandatory action" is INCORRECTLY matched?

(A) Risk Threshold 1 : Restriction on dividend distribution
(B) Risk Threshold 1 : Restriction on directors' or management compensation
(C) Risk Threshold 2 : Restriction on branch expansion
(D) Risk Threshold 3 : Appropriate restrictions on capital expenditure (other than technological upgradation)

Oct/Nov 2019

49. Consider the following statements regarding Discretionary Corrective Actions under the Prompt Corrective Action (PCA) framework:

I Strategy related
II Governance related
III Credit risk related
IV Market risk related
V Monetary policy related

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), (V)
(B) (I), (II), (III), (IV)
(C) (II), (III), (IV), (V)
(D) (I), (III), (IV), (V)

at their full market value during a liquidity stress event in the market.

32. (B) (I), (II), (IV), (V)
The prompt corrective action framework monitors capital, asset quality, and leverage to ensure banking stability. It applies to both domestic and foreign banks operating through branches. A bank can exit the framework if it shows sustained compliance over four continuous quarterly financial statements. Ensuring depositors have access to funds is also a critical goal to prevent damaging bank runs and contagion.

33. (A) P-2, Q-3, R-4, S-1
Severe run-off factors for liquidity stress testing vary by the type of outflow. Unscheduled draws on committed credit and liquidity facilities to retail and small business customers have a twenty percent severe factor, while credit facilities to other banks have a one hundred percent factor. Unscheduled draws on committed credit and liquidity facilities to non-financial corporates are assigned a forty percent factor, and secured short-term financing involving non-financial corporate bonds faces a fifty percent factor to reflect higher liquidity risks.

34. (D) Assertion (A) is false, but Reason (R) is true.
The assertion that the prompt corrective action framework excludes foreign banks is false, as it applies to all commercial banks operating in the jurisdiction. However, the reason provided is true, as supervising cross-border banks is inherently complex due to the national nature of regulatory tools and responsibilities. Regulators must coordinate across jurisdictions to effectively manage risks in global banking groups.

35. (C) Only (I) is correct.
Reverse stress testing is a process that identifies scenarios capable of making an institution's business model unviable. Its primary objective is to highlight extreme vulnerabilities and encourage proactive risk management, not to provide a false sense of security. By uncovering what could cause a failure, the bank can better prepare for rare but catastrophic events that standard stress tests might miss.

36. (A) ₹ 450 crore
Under the baseline liquidity outflow scenario, stable retail deposits are assigned a five percent run-off factor, and unstable retail deposits are assigned a ten percent factor. For five thousand crore rupees of stable deposits, the outflow is two hundred fifty crore. For two thousand crore of unstable deposits, it is two hundred crore. The combined expected total run-off amount is four hundred fifty crore.

37. (A) P-3, Q-4, R-1, S-2
Risk categories are matched with specific stress scenarios to evaluate vulnerabilities. Credit risk involves the slippage of restructured assets, while interest rate risk might include a yield curve inversion. Liquidity risk is characterized by significant daily deposit run-off rates. Equity price risk is tested using broad declines in market prices, such as a forty percent baseline drop across the board.

38. (B) (I), (II), and (III)
Banks are grouped for stress testing based on their total risk-weighted assets. Group A banks exceed two thousand billion rupees, Group B fall between five hundred and two thousand billion, and Group C are under five hundred billion. While groups A, B, and C are correctly defined, the implementation date for reverse stress testing for Group A was actually set for April 2013.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
It is beneficial for banks to use multiple stress testing methodologies simultaneously because different techniques capture different aspects of risk exposure. While sensitivity analysis isolates single factors, scenario analysis looks at integrated risk movements. By combining these approaches, the institution gains a more comprehensive and robust assessment of its vulnerabilities, leading to more effective risk management and capital planning.

40. (C) Unscheduled draws on retail and small business customers : 20%
In liquidity risk stress tests, the medium run-off factor for unscheduled draws on credit and liquidity facilities to retail and small business

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(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (I), (III), and (IV)
(D) (II), (III), and (IV)

May/June 2020

56. Match the Bank Classification Groups in List I with their Criteria/Action requirements in List II:

List I: (Bank Groups)
P. Group A
Q. Group B
R. Group C
S. Consolidated Group entities

List II: (Criteria/Requirements)
1. RWA between ₹ 500 billion and ₹ 2000 billion
2. Additional firm-wide programmes at a consolidated level
3. RWA less than ₹ 500 billion
4. Carry out stress testing with all complexities and severities

(A) P-4, Q-1, R-3, S-2
(B) P-1, Q-4, R-2, S-3
(C) P-4, Q-3, R-1, S-2
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2015

57. Gamma Bank's current Net NPA is ₹ 100 crore. Under the "Increase in NPAs" stress test (Shock 1), the bank conducts a "Medium" severity analysis. Based on standardized guidelines, what will be the assumed Net NPA level under this scenario?
(A) ₹ 150 crore
(B) ₹ 200 crore
(C) ₹ 250 crore
(D) ₹ 300 crore

May/June 2013

58. Consider the following statements regarding stress testing techniques:
I Sensitivity analyses illustrate how an institution's position changes when several risk factors are modified simultaneously.
II Scenario analyses take into consideration the inter-workings among risk factors and enable the capturing of risks in an integrated approach.
Which of the above statement(s) is/are correct?
(A) Both (I) and (II) are correct.
(B) Both (I) and (II) are incorrect.
(C) Only (I) is correct.
(D) Only (II) is correct.

Oct/Nov 2021

59. Consider the following statements regarding characteristics of a general market crisis scenario:
I A market-wide liquidity squeeze with severe contraction in availability of funding sources.
II Substantial discounts needed to sell or repo assets due to a flight to quality.
III Increasing requests from customers to redeem time deposits before maturity.
IV Restrictions on currency convertibility.
V Severe operational or settlement disruptions affecting payment systems.
Which of the above statement(s) is/are correct?
(A) (I), (II), (IV), (V)
(B) (I), (II), (III), (V)
(C) (I), (III), (IV), (V)
(D) (II), (III), (IV), (V)

May/June 2024

60. Consider the following statements regarding the minimum stress period for liquidity testing:
I An institution-specific crisis scenario should last for no less than five business days.
II A general market crisis scenario should last for no less than one calendar month.
III A combined scenario should last for no less than one calendar year.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

NODIA

Oct/Nov 2008

61. Under the Prompt Corrective Action (PCA) framework, a bank breaches Risk Threshold 2. The regulator, as a discretionary action, decides to remove certain managerial persons under applicable banking laws. This action falls under which category of the Common Menu?
(A) Special supervisory actions
(B) Strategy related actions

16. (A) An illustration of how an institution's position changes when a single risk factor is modified while others remain constant.
Sensitivity analysis is a straightforward stress testing technique that measures the impact of changing one specific risk variable at a time. By holding all other factors constant, the bank can isolate and understand the direct effect of that particular variable on its portfolio. This method is useful for identifying which individual risk factors have the most significant influence on stability.

17. (A) Generating guaranteed predictive forecasts to eliminate the probability of future market losses.
Stress testing is intended to be a diagnostic and forward-looking tool that supplements capital models and improves risk understanding. It helps identify vulnerabilities under extreme scenarios but cannot provide guaranteed predictive forecasts or eliminate the possibility of future losses. Its primary role is to enhance preparedness and resilience, acknowledging that financial markets are inherently unpredictable and carry unavoidable risks.

18. (B) An entity where the total average annual turnover is less than ₹ 50 crore.
In the context of liquidity risk management and stress testing, the classification of customers is essential for applying accurate run-off factors. A small business customer is specifically defined as an entity with a total average annual turnover of less than fifty crore rupees. This classification helps banks estimate the stability of deposits and potential liquidity outflows during stressful economic periods.

19. (D) Detailed Board level review of capital planning is a Strategy related action.
The prompt corrective action framework includes a menu of discretionary actions categorized by their nature. Governance-related actions include compensation restrictions, while operations-related actions involve reducing outsourcing. Human resources actions may involve reviewing staff training. However, a detailed board-level review of capital planning is categorized as a capital-related action rather than a strategy-related action under the standard regulatory framework.

20. (A) It identifies possible combinations of events that threaten the viability of the institution's business model.
Reverse stress testing is specifically designed to identify the exact point at which a bank's business model would fail. It searches for combinations of events and shocks that would lead to insolvency or a breach of critical thresholds. This method encourages a deeper exploration of tail risks and vulnerabilities that might not be captured by traditional forward-looking scenario analyses.

21. (B) (II), (IV), (I), (III)
The process of stress testing follows a logical sequence beginning with the identification of relevant market variables and potential movements to stress. Next, the bank must decide on the specific magnitude of the shocks and the relevant time frame. Once these parameters are set, the shocks are applied to the portfolio, and the results are revalued to determine the impact.

22. (A) $\geq 6.0\%$ but $< 9.0\%$
Under the prompt corrective action framework, asset quality is monitored using the net non-performing advances ratio. Risk threshold one is triggered when this ratio is at least six percent but remains below nine percent. Reaching this threshold alerts regulators to deteriorating asset quality, leading to mandatory remedial actions designed to stabilize the bank's financial health and protect stakeholders.

23. (D) An institution-specific scenario assumes the bank's liabilities cannot be rolled over due to perceived problems affecting public confidence in the bank.
An institution-specific crisis scenario focuses on risks unique to a particular bank, such as a loss of public confidence or a rating downgrade. In this scenario, the bank faces difficulties rolling over its liabilities as creditors and depositors withdraw support. This differs from a general market crisis, which involves systemic issues affecting all participants, such as a broad liquidity squeeze.

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results in a projected breach of its internal stress tolerance limits for capital adequacy. Following the stress testing framework, the senior management proposes "augmenting the capital levels" and "reducing exposure to high-risk sectors." What do these actions represent?

(A) Routine liquidity reporting
(B) Remedial actions
(C) Model validation mechanisms
(D) Sensitivity parameter setting

May/June 2022

70. Following a major financial crisis, Omikron Bank's Board decides they can no longer assume that a 0 percent probability means an event will never happen. They insist on modeling highly improbable events to build their contingency capital. This shift in risk philosophy is primarily driven by an understanding of:

(A) Standardized approach limits
(B) The Black Swan phenomenon
(C) The additive approach in liquidity modeling
(D) Disaster myopia in standard deviation models

NODIA

May/June 2009

50. Consider the following statements on definitions for liquidity stress testing:

I Retail deposits are defined as deposits placed in a bank by a natural person.

II All deposits other than stable deposits are defined as unstable deposits.

III Unsecured wholesale funding is defined exclusively as deposits from foreign banking groups.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2011

51. Omega Bank holds corporate bonds rated AA- worth ₹ 1,000 crore in its Held For Trading (HFT) portfolio. For calculating liquidity inflows during a "Medium" stress scenario, what haircut must the bank apply, and what will be the resultant recognized inflow?

(A) 15% haircut, resulting in ₹ 850 crore inflow
(B) 30% haircut, resulting in ₹ 700 crore inflow
(C) 50% haircut, resulting in ₹ 500 crore inflow
(D) 60% haircut, resulting in ₹ 400 crore inflow

May/June 2010

52. Which of the following pairs of "Credit Risk Shock" and its "Baseline stress factor" is correctly matched?

(A) Shock 3 (Increase in NPA in Specific Sectors) : Additional 5 percentage points increase
(B) Shock 5 (Depletion in collateral) : 20 per cent depletion
(C) Shock 6 (Downgrade in counter-party rating) : Uniform downgrade by two notches
(D) Shock 4 (Slippage of Restructured Standard Assets) : 20 per cent additional slippages

Oct/Nov 2024

53. Consider the following statements regarding Interest Rate Risk:

I The immediate impact of changes in interest rates is on a bank's Market Value of Equity (MVE) through the 'economic value' perspective.

II A long-term impact of changes in interest rates is on a bank's earnings through changes in its Net Interest Income (NII).

Which of the above statement(s) is/are correct?

(A) Both (I) and (II) are correct.
(B) Both (I) and (II) are incorrect.
(C) Only (I) is correct.
(D) Only (II) is correct.

May/June 2017

54. The following question consists of two statements, one labeled as "Assertion (A)" and the other as "Reason (R)". Examine these two statements carefully and select the correct answer using the codes given below.

Assertion (A): In designing a combined scenario, it is generally inappropriate for banks to adopt an "additive approach" by simply summing up underlying assumptions.

Reason (R): As a greater number of financial institutions are affected, the interaction of stress circumstances may change the way institution-specific elements behave, requiring adjusted severity.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2005

55. Consider the following statements regarding Prompt Corrective Action (PCA) risk thresholds:

I Risk Threshold 1 for Asset Quality is Net NPA ratio $\geq 6.0\%$ but $< 9.0\%$.

II Risk Threshold 3 for Capital is breach of CRAR in excess of 400 bps below the prescribed indicator.

III Risk Threshold 2 for Leverage is Up to 50 bps below the regulatory minimum.

IV Breach of either CRAR or CET 1 ratio can trigger PCA.

Which of the above statement(s) is/are correct?

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8. (B) Breach of any risk threshold in Capital, Asset Quality, or Leverage may result in the invocation of PCA.
The prompt corrective action framework monitors specific indicators related to capital adequacy, asset quality, and leverage. If a bank breaches the defined risk thresholds in any of these three areas, the regulator may invoke the framework. This ensures that weaknesses are addressed promptly, regardless of whether they originate from poor asset performance, low capital buffers, or excessive leverage.

9. (B) Restriction on branch expansion.
When a bank enters the first risk threshold of the prompt corrective action framework, certain mandatory actions are triggered. These typically include restrictions on dividend distributions, limits on the remittance of profits for foreign banks, and requirements for owners to bring in additional capital. However, restrictions on branch expansion are generally reserved for more severe breaches under the second threshold.

10. (C) By introducing forward-looking elements that identify severe events or market changes impacting the bank's stability.
Stress testing serves as a vital complement to the internal capital adequacy assessment process by providing a forward-looking perspective on risk. While traditional models often rely on historical data, stress tests explore the impact of extreme events and structural market changes. This allows banks to identify potential vulnerabilities that could threaten their stability and ensure they hold sufficient capital.

11. (C) (II), (III), (I)
For credit risk stress testing concerning an increase in non-performing assets, regulators specify three levels of shocks to represent varying degrees of severity. The baseline shock assumes a fifty percent increase in net non-performing assets. This is followed by a medium shock of one hundred percent and a severe shock of one hundred and fifty percent, following an escalating sequence.

12. (B) At least for five years
Banks are required to maintain a comprehensive record of their stress testing activities to ensure transparency and regulatory compliance. Documentation must include the methodologies used, all underlying assumptions, the final results, and the resulting management outcomes. These records must be preserved for a minimum period of five years to allow for supervisory review and internal auditing of the process.

13. (D) The medium shock for parallel upward/downward shift of the yield curve is 500 bps.
Standardized single factor stress tests for interest rate risk define specific shocks for yield curve movements. For a parallel shift, the baseline shock is set at two hundred basis points, and the medium shock is defined as three hundred basis points. Claiming the medium shock is five hundred basis points is incorrect according to the established regulatory guidelines for these tests.

NODIA

14. (C) Assumptions should be well documented, reviewed periodically, and available for verification by supervisors.
A robust stress testing framework requires that all underlying assumptions be clearly documented and justified. These assumptions must undergo regular periodic reviews to ensure they remain relevant to the current market environment. Furthermore, the entire process and its documentation must be accessible to regulatory supervisors for verification, ensuring the bank's risk assessments are rigorous and technically sound.

15. (D) Indicative information that helps in understanding risk shapes and improving overall resilience.
Senior management should view stress test results as valuable indicative information rather than exact predictions of the future. These results help clarify the nature and shape of risks the institution faces under extreme conditions. By understanding these vulnerabilities, management can take proactive steps to improve the bank's overall resilience, adjust risk appetites, and refine internal capital planning processes.

ANSWERS

1. (B) 20% depreciation in 30 days
Regulatory guidelines for single factor stress tests in foreign exchange risk prescribe specific shock levels based on the severity of the economic scenario. For the depreciation of the local currency, a severe shock is defined as a twenty percent decline within a thirty-day timeframe. This helps banks evaluate their resilience against sudden and significant currency fluctuations impacting their capital position.

2. (C) Group C banks are expected to carry out complex macro scenario exercises and regular reverse stress testing.
Banking institutions are classified into three groups based on their total risk-weighted assets to determine the complexity of required stress tests. Group A banks, with assets exceeding two thousand billion rupees, must perform complex macro scenarios and reverse stress testing. In contrast, Group C banks with smaller asset sizes are only required to conduct simpler sensitivity analysis of specific risks.

3. (C) Identifying a severe negative outcome and then identifying the causes and consequences that could lead to such an event.
Reverse stress testing is a risk management tool that starts by assuming a bank's business model has become unviable or a specific adverse outcome has occurred. It then works backward to identify the scenarios, causes, and consequences that could lead to such failure. This process helps institutions understand their vulnerabilities and the limits of their current risk management strategies.

4. (C) Seemingly improbable events are more likely than believed, necessitating forward-looking stress testing.
The concept of a black swan event emphasizes that highly improbable occurrences can happen and cause massive impacts. Relying solely on historical data can lead to disaster myopia, where risks outside recent experience are ignored. Consequently, banks must implement forward-looking stress testing to prepare for extreme but plausible scenarios that standard statistical models might fail to predict accurately.

5. (B) To start corrective action early, before capital triggers are reached, based on risk assessment and market signals.
The prompt corrective action framework is designed to intervene in a bank's operations at an early stage. By using risk-based triggers and market signals, the regulator can initiate remedial measures before capital levels fall below critical thresholds. This proactive approach aims to restore the financial health of the institution and prevent systemic instability within the broader banking sector.

6. (B) It should attempt to qualitatively analyse the interactions among risk types and at least address firm-wide stress testing in a qualitative manner.
Group C banks are smaller institutions with total risk-weighted assets below five hundred billion rupees. While they are not mandated to perform the complex, quantitative, firm-wide scenario analyses required of larger banks, they should still consider risk interactions. These banks are encouraged to qualitatively assess how different risk types might interact and influence their overall stability during stressful periods.

7. (B) The evaluation of a bank's financial position under a severe but plausible scenario to assist in internal decision making.
Stress testing is a fundamental risk management technique used to evaluate the potential impact of extreme but plausible events on a bank's financial health. It involves simulating adverse scenarios to assess how specific variables affect capital and liquidity. This process provides crucial information for senior management to make informed decisions regarding risk appetite, capital planning, and contingency strategies.

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24. (D) Marketable non-financial sector corporate bonds rated AA- or better.
For liquidity inflow calculations, assets are categorized into different levels based on their liquidity. Level 2B assets typically include residential mortgage-backed securities, certain corporate bonds rated between A plus and BBB minus, and specific equity shares. Corporate bonds rated AA minus or better are generally classified as higher-quality Level 2A assets, which have lower haircuts and different inclusion criteria.

25. (B) A single universally accepted methodology for stress testing exists that all institutions must adopt.
Stress testing is a flexible process where banks identify potential market movements, make assumptions, and revalue portfolios to observe profit and loss effects. There is no single, universally mandated methodology that applies to every institution. Instead, banks are encouraged to use various techniques, including sensitivity and scenario analysis, tailored to their specific size, complexity, and unique risk profile.

26. (D) Insured deposits in transactional accounts where salaries are automatically credited or payments are paid out from.
Stable deposits are those retail deposits that are considered less likely to be withdrawn during a liquidity stress event. They are typically characterized by being fully insured and held in transactional accounts, such as those used for salary credits or regular bill payments. These established banking relationships increase the likelihood that the funds will remain with the bank during a crisis.

27. (A) Modulating the severity of assumptions based on how the different stress circumstances interact.
When designing a combined stress scenario that incorporates both institution-specific and market-wide crises, banks should avoid a simple additive approach. Instead, they must evaluate how different stress factors interact and potentially amplify one another. This requires modulating the severity of assumptions to reflect the complex dynamics that occur when a specific bank's problems coincide with broader financial market instability.

28. (A) It fails to reflect actual exposures because real-life risk factors impact the portfolio in combination rather than stand-alone.
Sensitivity analysis is limited because it only modifies one risk factor at a time while keeping others constant. In reality, financial crises often involve multiple risk factors changing simultaneously and interacting in complex ways. Consequently, sensitivity analysis may fail to capture the true magnitude of potential losses, making more comprehensive scenario analysis essential for a realistic assessment of exposures.

29. (C) Interbank deposits being repaid before maturity.
An institution-specific crisis scenario involves events that drain a bank's liquidity, such as rapid deposit run-offs, the loss of secured and unsecured funding, and the forced sale of securities at deep discounts. However, interbank deposits being repaid before maturity would represent a liquidity inflow. In a crisis, the concern is that other banks will not provide or renew funding.

30. (D) The medium run-off factor for credit facilities to non-financial corporates is 20%.
Liquidity stress tests use specific run-off factors to estimate unscheduled draws on committed facilities. For non-financial corporate customers, the medium severity scenario assumes a twenty percent run-off rate for credit and liquidity facilities. These factors help banks quantify potential liquidity needs during periods of stress, ensuring they maintain adequate high-quality liquid assets to cover unexpected demands from their clients.

31. (C) Corporate bond with rating between A+ and BBB- : 50%
Liquidity inflow calculations require applying haircuts to various securities held in the trading portfolio. For corporate bonds with a credit rating between A plus and BBB minus, a baseline haircut of fifty percent is specified. This significant haircut reflects the potential difficulty in selling these lower-rated securities

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(C) Governance related actions
(D) Credit Risk related Actions

May/June 2006

62. Theta Bank has Total Risk Weighted Assets of ₹ 1,200 billion. As per the stress testing classification, it is preparing its framework for the upcoming year. What specific methodologies is Theta Bank required to undertake?
(A) Multifactor sensitivity analysis and scenario analyses with respect to movements in multiple factors.
(B) Simple sensitivity analyses of isolated risk factors without considering potential correlations.
(C) Complex macro scenario driven firm-wide exercises and mandatory regular reverse stress testing.
(D) International firm-wide stress testing programmes conducted at a consolidated level for groups.

Oct/Nov 2017

63. Epsilon Bank reports a Net NPA ratio of 12.5% in its audited annual financial statement. Under the Prompt Corrective Action (PCA) framework, what regulatory status is triggered by this metric?
(A) It falls under Risk Threshold 1.
(B) It falls under Risk Threshold 2.
(C) It falls under Risk Threshold 3.
(D) The PCA framework relies solely on CRAR, so no threshold is breached.

May/June 2008

64. Rho Bank is calculating liquidity risk stress outflows. It has ₹ 200 crore of committed but unused credit facilities to non-financial corporates. Under the "Severe" scenario, what is the amount of unscheduled drawdowns the bank must assume?
(A) ₹ 20 crore
(B) ₹ 40 crore
(C) ₹ 80 crore
(D) ₹ 100 crore

Oct/Nov 2013

65. During a global financial crisis, Kappa Bank decides to merge an institution-specific deposit run scenario with a market-wide liquidity squeeze scenario. The risk officers decide that selling debt securities will fetch even lower realizable values than previously modeled because few participants have liquidity. They adjust the discount factors downward rather than simply summing the original discounts. This reflects the treatment of:
(A) Reverse Stress Testing
(B) Combined scenarios
(C) A pure baseline sensitivity test
(D) Disaster myopia

May/June 2015

66. Alpha Bank is asked by the regulator to calculate how much depreciation in the local currency would be necessary for its Tier I capital to move down to 3 percent over 60 days. This specific methodology is an example of which risk management technique?
(A) General market crisis scenario analysis
(B) Parallel yield curve shift analysis
(C) Capital conservation buffering
(D) Reverse Stress Testing

Oct/Nov 2012

67. A retail bank simulates a severe crisis where public confidence is lost. They assume no head office funding support is available, significant daily deposit run-offs occur, and marketable securities must be sold at forced discounted prices. This exercise primarily exemplifies:
(A) Reverse Stress Testing
(B) An economic value perspective sensitivity test
(C) A PCA withdrawal assessment
(D) An institution-specific crisis scenario

NODIA

May/June 2011

68. Lambda Bank's Asset-Liability Management (ALM) desk assesses its interest rate risk for both the trading and banking book. They apply a parallel upward shift of the yield curve by 300 bps. Under standardized single factor stress tests, which severity level does this represent?
(A) Minor
(B) Baseline
(C) Medium
(D) Severe

Oct/Nov 2020

69. During its quarterly ICAAP review, Beta Bank discovers that its "Severe" stress scenario

customers is actually ten percent. Using twenty percent for this category is incorrect based on standardized regulatory guidelines. Other factors, such as twenty-five percent for stable wholesale deposits and seventy-five percent for Level 2B assets, are correctly identified.

41. (B) Risk Threshold 2
The prompt corrective action framework monitors breaches in the capital to risk assets ratio. If a bank's ratio falls significantly below the regulatory minimum plus the capital conservation buffer, it enters specific risk thresholds. A shortfall of three hundred and fifty basis points exceeds the first threshold and places the bank into the more serious risk threshold two category.

42. (A) P-4, Q-1, R-3, S-2
Prompt corrective action thresholds for the leverage ratio are based on the degree of breach from the regulatory minimum. Threshold one applies for breaches up to fifty basis points. Threshold two covers breaches between fifty and one hundred basis points. Threshold three is for breaches exceeding one hundred basis points. Banks that remain compliant with the regulatory minimum are considered in normal operations.

43. (D) (I), (II), (III), and (IV)
When stress tests indicate that tolerance levels have been breached, banks must take remedial actions. These include reducing risk limits, increasing collateral requirements, and amending pricing policies to account for higher risks. Furthermore, the bank may need to augment its capital levels to rebuild its buffer. All these measures work together to restore the institution's financial stability and risk profile.

44. (D) (I), (II), and (III)
Annual reviews of a stress testing framework must be comprehensive to ensure its effectiveness. These reviews should check the adequacy of documentation and confirm that stress testing is integrated into daily risk management. Additionally, the integrity of management information systems and the data feeding into the tests must be verified to ensure that the results are reliable and can support decision-making.

45. (B) 20 percent depreciation in 30 days
For assessing foreign exchange risk, the severe shock scenario for the depreciation of the local currency is defined as a twenty percent decline over thirty days. This parameter allows the bank to evaluate the potential loss and capital impact under extreme currency volatility. Using this standardized shock ensures that the bank's stress testing is rigorous and consistent with regulatory expectations.

46. (A) P-3, Q-4, R-1, S-2
Credit risk shocks are categorized by their specific impact on the portfolio. Shock two focuses on increased non-performing assets in the top five industries. Shock five addresses the depletion of collateral value. Shock six involves a downgrade in counter-party ratings, while shock eight simulates a group default by the largest borrower. These tests help banks understand their exposure to concentration and credit quality risks.

47. (D) Assertion (A) is false, but Reason (R) is true.
Stress tests are designed to explore extreme scenarios but do not provide an explicit statistical likelihood of those events occurring. This makes the assertion false. However, the reason is true because the design of stress tests is heavily dependent on the qualitative judgment and experience of risk professionals. They must use their expertise to determine which scenarios are plausible and relevant.

48. (B) Risk Threshold 1 : Restriction on directors' or management compensation
Under the prompt corrective action framework, restrictions on dividend distributions and profit remittances are mandatory for risk threshold one. However, restrictions on directors' or management compensation are categorized as discretionary actions. Misattributing compensation restrictions to mandatory actions for threshold one is incorrect according to the regulatory framework for banks.

49. (B) (I), (II), (III), (IV)
The common menu of discretionary corrective actions under the prompt corrective action framework covers several categories. These include strategy, governance, credit risk, and

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market risk-related actions. However, monetary policy actions are handled independently by the central bank and are not part of the corrective measures applied to individual banks under the prompt corrective action framework's institutional risk-based intervention.

50. (A) Only (I) and (II)
For liquidity stress testing, retail deposits are defined as those from natural persons. Unstable deposits are those not meeting the criteria for stable deposits. While unsecured wholesale funding includes various non-natural person sources, it is not exclusively limited to foreign banking groups. Therefore, only the first two definitions provided are correct according to the standardized terminology used in liquidity risk management.

51. (B) 30% haircut, resulting in ₹ 700 crore inflow
In a medium stress scenario, corporate bonds rated AA minus held in the trading portfolio are subject to a thirty percent haircut. For an initial value of one thousand crore rupees, this results in a recognized liquidity inflow of seven hundred crore rupees. This calculation helps the bank determine its available liquidity by accounting for the potential loss in value during a crisis.

52. (D) Shock 4 (Slippage of Restructured Standard Assets) : 20 per cent additional slippages
The baseline stress factor for the slippage of restructured standard assets is set at twenty percent. This shock measures the impact of credit quality deterioration in specifically identified sensitive portions of the loan book. Correctly matching these baseline factors is essential for banks to perform accurate and standardized credit risk stress tests that align with the regulator's minimum expectations.

53. (B) Both (I) and (II) are incorrect.
Changes in interest rates impact a bank in two ways, but the perspectives are swapped in the statements. The immediate impact on earnings through net interest income is the earnings perspective, while the long-term impact on the market value of equity is the economic value perspective. Since the statements misidentified these concepts, both are considered incorrect according to standard banking theory.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
When combining institution-specific and market-wide stress scenarios, banks should not simply add the impacts together. This is because risk factors can interact in non-linear ways during a systemic crisis, potentially changing the behavior of individual variables. A more sophisticated approach that adjusts the severity of assumptions to account for these complex interactions is necessary for a realistic and accurate stress test.

NODIA

55. (B) (I), (II), and (IV)
The prompt corrective action framework uses specific indicators for risk thresholds. Threshold one for asset quality is a net non-performing asset ratio between six and nine percent. For capital, threshold three is triggered by a breach exceeding four hundred basis points. Furthermore, a breach in either the total capital ratio or the common equity tier one ratio can trigger intervention.

56. (A) P-4, Q-1, R-3, S-2
Banks are categorized into groups A, B, and C based on their risk-weighted assets to determine stress testing requirements. Group A performs the most complex tests, while Group B includes banks with assets between five hundred and two thousand billion rupees. Group C consists of smaller institutions. Consolidated group entities are also required to perform additional firm-wide programs at a global level.

57. (B) ₹ 200 crore
The medium severity shock for an increase in non-performing assets is defined as a one hundred percent increase over the current level. For a bank with one hundred crore rupees in net non-performing assets, this shock results in a total assumed level of two hundred crore rupees. This doubling of the non-performing assets helps the bank assess its potential capital depletion.

58. (D) Only (II) is correct.
Scenario analysis is a comprehensive technique that considers the simultaneous movement of multiple risk factors and their interconnections. This provides an integrated view of risk.

Sensitivity analysis, on the other hand, typically modifies only a single factor at a time. Therefore, only the statement regarding scenario analysis accurately describes the integrated approach required for capturing complex risk interactions in stress testing.

59. (A) (I), (II), (IV), (V)
A general market crisis involves systemic issues such as a contraction in funding, flight to quality causing asset discounts, currency convertibility restrictions, and disruptions in national payment systems. While deposit redemptions occur, they are specifically highlighted as a core feature of institution-specific scenarios where confidence in a particular bank is lost. The other four characteristics define the broader market-wide liquidity squeeze scenario.

60. (A) Only (I) and (II)
Minimum stress periods are defined to ensure banks test their resilience over adequate timeframes. An institution-specific crisis scenario must last at least five business days, while a general market crisis scenario should last for a minimum of one calendar month. However, there is no standardized regulatory requirement that a combined scenario must last for a full calendar year in these specific guidelines.

61. (C) Governance related actions
The prompt corrective action framework includes a common menu of discretionary actions that the regulator can take based on the severity of a bank's situation. Removing managerial persons or board members falls under the category of governance-related actions. These measures aim to address leadership or management failures that may have contributed to the bank's financial distress and threshold breaches.

62. (A) Multifactor sensitivity analysis and scenario analyses with respect to movements in multiple factors.
Theta Bank is classified as a Group B bank because its risk-weighted assets are between five hundred and two thousand billion rupees. As a result, it is required to go beyond simple sensitivity analysis and perform multifactor sensitivity tests and scenario analyses. These methods allow the bank to evaluate the combined impact of various risk factors on its financial position and stability.

63. (C) It falls under Risk Threshold 3.
Under the prompt corrective action framework, asset quality is measured by the net non-performing advances ratio. A ratio that is twelve percent or higher triggers the most severe risk threshold three. This classification subjects the bank to more intensive regulatory intervention and a wider range of mandatory and discretionary corrective actions designed to address the critical level of non-performing assets.

64. (C) ₹ 80 crore
For liquidity stress testing, the severe scenario assumes a forty percent run-off factor for unscheduled draws on committed credit facilities to non-financial corporate customers. For an unused facility of two hundred crore rupees, the bank must assume an outflow of eighty crore rupees. This calculation helps the bank ensure it has enough liquidity to meet potential demands from its corporate clients during a crisis.

65. (B) Combined scenarios
A combined scenario integrates elements of both institution-specific and general market crises. In this case, the bank is adjusting its assumptions to account for how a systemic liquidity squeeze can amplify the problems of an individual bank facing a deposit run. This approach captures the complex interactions between different stress factors, providing a more realistic and severe test of the bank's resilience.

66. (D) Reverse Stress Testing
The exercise described involves identifying a critical failure point, such as capital falling to three percent, and then determining what conditions would cause it. This is the hallmark of reverse stress testing. Unlike standard stress tests that apply a shock to see the outcome, reverse stress testing starts with a severe outcome and identifies the magnitude of the shock required to reach it.

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(D) It encourages excessive risk-taking by guaranteeing higher market prices for all complex financial instruments.

May/June 2024

7. What does the concept of market discipline primarily refer to in the context of banking regulations?
(A) The framework establishing minimum capital reserves that banks must maintain against operational risks.
(B) The ability of market participants to influence a financial institution's behavior through monitoring its risk profile.
(C) The supervisory review process conducted by the central bank to ensure regulatory compliance.
(D) The internal audit mechanisms designed to protect a bank's proprietary and confidential information.

Oct/Nov 2017

8. Which statement accurately depicts the publication requirements for Pillar 3 disclosures?
(A) Pillar 3 disclosures must be published with a deliberate delay of one quarter after the financial results.
(B) Pillar 3 disclosures should be made concurrent with the publication of financial results or statements.
(C) Banks are forbidden from making voluntary disclosures beyond what is statutorily mandated.
(D) Banks must prioritize print publication over website publication for all regulatory disclosures.

May/June 2011

9. Market participants face difficulties in processing information due to several factors. Which of the following is NOT cited as a contributing factor?
(A) The rapid development of new financial instruments over the last two decades.
(B) The reduction of business lines exclusively to simple retail lending operations.
(C) The structuring of financial institutions as intricate ownership hierarchies.
(D) The receipt of a substantial portion of income from noninterest activities.

Oct/Nov 2023

10. Why do uninsured depositors naturally have a strong incentive to monitor the risk-taking behavior of banks?
(A) They are legally mandated by the regulator to perform quarterly risk assessments.
(B) They receive a fixed percentage of the bank's noninterest income as a bonus.
(C) They have money at stake and can lose their funds if the bank fails.
(D) They are provided with proprietary access to the bank's internal validation systems.

May/June 2016

11. Arrange the logical sequence of steps a bank must take to comply with general disclosure principles:
1. The Board of directors approves a formal disclosure policy.
2. Management implements internal controls and assesses the appropriateness of disclosures.
3. Disclosures are validated through appropriate verification.
4. Disclosures are published concurrently with financial results or on the website.

Which of the following represents the correct sequence?
(A) 2, 1, 3, 4
(B) 1, 2, 3, 4
(C) 1, 3, 2, 4
(D) 3, 1, 4, 2

Oct/Nov 2009

12. Under the Basel capital regulations, market discipline was introduced to complement official oversight. Which pillar represents market discipline?
(A) Pillar 1
(B) Pillar 2
(C) Pillar 3
(D) Pillar 4

NODIA

May/June 2021

13. Identify the incorrect statement concerning the consequences of non-compliance with disclosure requirements.
(A) Direct additional capital requirements are the standard and automatic response to any non-disclosure.
(B) Non-compliance with the prescribed disclosure requirements would attract a

CHAPTER 30
Market Discipline

May/June 2013

1. With the exception of specific regulatory tables, what is the minimum required frequency for banks to make Pillar 3 disclosures?
(A) On a monthly basis
(B) On a quarterly basis
(C) On an annual basis
(D) On a half-yearly basis

Oct/Nov 2008

2. Identify the incorrect statement related to the validation of Pillar 3 disclosures.
(A) Information contained within the annual financial statements would generally be subject to an external audit.
(B) Supplementary material such as Management's Discussion and Analysis must be subjected to sufficient scrutiny.
(C) Pillar 3 disclosures require mandatory auditing by an external auditor in all standard circumstances.
(D) Additional material published with annual statements must be consistent with the audited statements.

May/June 2025

3. Which definition best characterizes confidential information in banking disclosures?
(A) Information regarding internal methodologies and parameter estimates that dictates market risk.
(B) Information that would render a bank's investment in specific systems less valuable if leaked.
(C) Information provided under the terms of a legal agreement or counterparty relationship.
(D) Information related to the statutory reserves maintained by the institution with the central bank.

Oct/Nov 2019

4. What is the most appropriate reason why a bank might choose to disclose information beyond the mandatory statutory requirements?
(A) To trigger automatic and permanent exemptions from Pillar 2 supervisory reviews by the central bank.
(B) To reduce the reporting burden associated with the standard half-yearly regulatory data submission process.
(C) To ensure the investing community is kept informed, acting as a proactive risk management tool.
(D) To fulfill the mandatory external audit criteria set by the Basel Committee for all international banks.

May/June 2007

5. How should the validation of Pillar 3 disclosures be handled if the material is published in a stand-alone report outside the audited financial statements?
(A) The regulator must perform an independent audit of the stand-alone report prior to publication.
(B) Management must ensure that appropriate verification of the information takes place internally.
(C) The external auditor must issue a separate certificate of compliance for the stand-alone report.
(D) The stand-alone report is exempt from any validation requirements due to its separate nature.

Oct/Nov 2010

6. What is the most appropriate description of how market discipline impacts a financial institution's risk-taking incentives?
(A) It eliminates all forms of risk-taking by transferring the risk entirely to the regulatory body.
(B) It makes risk-taking costlier as uninsured depositors demand higher rates when a bank takes on more risk.
(C) It subsidizes risk-taking by providing state-sponsored insurance for all unsecured creditors.

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67. (D) An institution-specific crisis scenario
A scenario where a bank faces a loss of public confidence, leading to rapid deposit withdrawals and the inability to access head office or market funding, is an institution-specific crisis. This type of stress test focuses on vulnerabilities unique to that specific institution rather than broader market issues. It forces the bank to evaluate its contingency plans for a localized and severe liquidity event.

68. (C) Medium
Standardized stress tests for interest rate risk define levels of parallel yield curve shifts. A two hundred basis point shift is the baseline, while a three hundred basis point shift is categorized as medium. A four hundred basis point shift represents the severe scenario. Therefore, Lambda Bank's application of a three hundred basis point shift corresponds to the medium severity level of stress.

69. (B) Remedial actions
When stress test results indicate that a bank's capital or liquidity might fall below acceptable levels, the institution must propose and implement remedial actions. Measures such as augmenting capital, reducing exposure to risky sectors, or adjusting risk limits are standard responses to the vulnerabilities uncovered by the testing process. These actions are intended to bring the bank's risk profile back within safe limits.

70. (B) The Black Swan phenomenon
The understanding that highly improbable events can and do occur is central to the black swan phenomenon. Risk management based solely on normal distributions and historical data often fails to account for these rare events with massive impacts. By incorporating such possibilities into their stress testing framework, the bank is moving away from disaster myopia and building a more resilient capital buffer.

NODIA

financial penalty.
(C) Financial penalties imposed by the regulator must be disclosed in the bank's annual report and balance sheet.
(D) From a risk perspective, non-compliance acts as a significant stumbling block in building up reputation.

Oct/Nov 2016

14. Which statement accurately reflects the relationship between Pillar 3 disclosures and risk management?
(A) Pillar 3 disclosures replace the need for the supervisory review process detailed under Pillar 2.
(B) Providing disclosures based on a common framework diminishes the comparability of financial institutions.
(C) Bank disclosures should be consistent with how senior management and the Board assess and manage risks.
(D) The disclosure standards function as a substitute for minimum capital requirements under Pillar 1.

May/June 2005

15. How does the concept of the "user test" best function within the framework of materiality?
(A) It provides a strict mathematical formula to calculate the exact monetary threshold for mandatory disclosure.
(B) It serves as a mandatory survey conducted among retail depositors to determine their investment preferences.
(C) It replaces the International Accounting Standards for determining corporate tax liabilities of the bank.
(D) It acts as a qualitative benchmark to judge whether a user would consider an item material.

Oct/Nov 2012

16. How is proprietary information defined within the disclosure requirements?
(A) Data on systems or products whose public release would damage a bank's competitive standing.
(B) Data provided by bank clients under the specific terms of a legally binding confidentiality agreement.
(C) Data whose omission or misstatement could alter the economic decisions of a financial statement user.
(D) Data disclosed on the bank's website concurrently with the publication of audited annual statements.

NODIA

May/June 2019

17. The regulatory guidelines protect certain types of information from mandatory public disclosure. Banks are generally required to disclose comprehensive details, EXCEPT when the information is:
(A) Classified as proprietary information that would undermine competitive position.
(B) Related to the minimum capital requirements calculated under Pillar 1.
(C) Pertaining to the general methodologies utilized for assessing credit risk.
(D) Disclosed within the audited annual financial statements.

Oct/Nov 2020

18. Where must a bank prominently provide the direct link to its 'Regulatory Disclosures Section'?
(A) On the home page of the bank's website
(B) Within the internal employee intranet portal
(C) At the end of the printed annual report
(D) In the national daily newspapers

May/June 2012

19. Identify the incorrect statement about the general disclosure principles.
(A) A bank must provide a direct link in its financial statements to its website if including the full disclosures within the printed statements is operationally inconvenient.
(B) Disclosures have both statutory and voluntary dimensions.
(C) Going public on information fosters better discipline in risk management.
(D) All banks are required to submit Table DF-2 on a half-yearly basis along with other standard tables.

Oct/Nov 2014

20. Which statement is correct regarding the materiality thresholds for disclosures?
(A) Thresholds are prescribed for limited disclosures to facilitate a smooth transition and greater comparability.

(B) The regulator strictly prohibits banks from making any disclosures that fall below the specified materiality levels.
(C) Materiality is determined solely by quantitative formulas without the use of qualitative judgment by the reporting user.
(D) The user test benchmark has been entirely replaced by absolute statutory numerical limits for all participating banks.

May/June 2009

21. Arrange the following events in the correct sequential flow demonstrating the mechanism of market discipline:
1. Uninsured depositors face potential losses.
2. The bank takes on excessive risk.
3. Regulators use market signals to discipline the bank.
4. Depositors demand higher interest rates, driving up market prices.

Which of the following represents the correct sequence?
(A) 2, 1, 4, 3
(B) 1, 2, 3, 4
(C) 2, 4, 1, 3
(D) 4, 1, 2, 3

Oct/Nov 2011

22. Who is responsible for approving a bank's formal disclosure policy?
(A) The central bank
(B) The Board of Directors
(C) The external auditor
(D) The Chief Risk Officer

May/June 2023

23. What is the intended direct regulatory sanction if a bank fails to make a disclosure that serves as a qualifying criterion under Pillar 1?
(A) The bank is subjected to an immediate suspension of its banking license.
(B) The bank is forced to disclose its proprietary system architectures to competitors.
(C) The bank is required to double the frequency of its external financial audits.
(D) The bank is prohibited from applying lower risk weightings or specific methodologies.

Oct/Nov 2018

24. Effective market discipline requires participants to have incentives to monitor banks. All of the following are explicitly identified as having naturally strong incentives, EXCEPT:
(A) Large depositors
(B) Shareholders
(C) Unsecured creditors
(D) Fully insured retail depositors

May/June 2018

25. Identify the incorrect statement regarding market discipline.
(A) Market discipline was introduced as the third pillar of the Basel capital regulations.
(B) Stringent disclosure rules and independent audits decrease transparency in financial markets.
(C) Uninsured debtholders require reliable financial information to effectively monitor their investments.
(D) Regulators can use higher market prices as a valuable signal of greater risk-taking by banks.

Oct/Nov 2007

26. Based on the materiality concept, when is financial information regarded as material?
(A) When it is explicitly mandated by the Basel Committee on Banking Supervision for all banks.
(B) When it exceeds the absolute numerical threshold set by the national accounting framework.
(C) When it is certified by an external auditor during the annual financial review process.
(D) When its omission or misstatement could change or influence the assessment or decision of a user.

May/June 2022

27. If a bank finds it operationally inconvenient to make Pillar 3 disclosures alongside its published financial results, what is the best prescribed alternative?
(A) Provide a direct link in the financial results to the disclosures found on the bank's website.
(B) Defer the disclosures until the next financial year's annual report is prepared and published.
(C) Submit a confidential copy of the disclosures exclusively to the central bank for internal review.
(D) Publish an abbreviated summary in a

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national newspaper without including the full data tables.

Oct/Nov 2015

28. How do rapid developments of new financial instruments impact the effectiveness of market discipline?
(A) They increase the complexity and opacity of bank balance sheets for market participants.
(B) They simplify the evaluation of capital adequacy for retail shareholders during annual audits.
(C) They decrease the frequency with which banks must publish Table DF-2 on capital adequacy.
(D) They eliminate the need for banks to maintain an independent and formal disclosure policy.

May/June 2006

29. All of the following specific tables are required to be disclosed on a quarterly basis, EXCEPT:
(A) Table DF-2: Capital Adequacy
(B) Table DF-3: Credit Risk: General Disclosures for All Banks
(C) Table DF-5: Operational Risk: General Disclosures for All Banks
(D) Table DF-4: Credit Risk: Disclosures for Portfolios Subject to the Standardized Approach

Oct/Nov 2022

30. Which statement correctly describes the interaction between Pillar 3 disclosures and accounting standards?
(A) Pillar 3 disclosures supersede and effectively replace all national accounting standards for financial institutions.
(B) Accounting standards strictly prohibit the publication of voluntary Pillar 3 disclosures to prevent user confusion.
(C) The Basel Committee designed Pillar 3 specifically to override and invalidate current international accounting frameworks.
(D) The narrow focus of Pillar 3 on capital adequacy does not conflict with broader accounting requirements.

May/June 2014

31. Identify the correctly matched pair regarding market dynamics.
(A) Uninsured lenders : Lack any incentive to monitor bank activities
(B) Stand-alone reports : Exempt from all management verification
(C) High market prices for debt : Valuable signal of greater risk-taking
(D) Direct Capital Penalty : Standard response to all non-disclosures

Oct/Nov 2025

32. Consider the following statements regarding the fundamentals of market discipline:
I It serves as the third pillar of the Basel capital regulations.
II It relies on participants such as shareholders and rating agencies.
III It aims to make risk-taking cheaper for financial institutions.
IV It functions as a systemic force to improve risk management performance.
V Its disclosures should align with senior management's risk assessment methods.
Which of the above statement(s) is/are correct?
(A) Statements (I), (II), (III), and (IV)
(B) Statements (I), (II), (IV), and (V)
(C) Statements (II), (III), (IV), and (V)
(D) Statements (I), (III), (IV), and (V)

NODIA

May/June 2020

33. Match the specific tables in List I with their disclosure subjects in List II.
List I: (Disclosure Table)
P. Table DF-2
Q. Table DF-3
R. Table DF-4
S. Unspecified Pillar 3 Disclosures
List II: (Disclosure Subject)
1. Credit Risk: Disclosures for Portfolios Subject to the Standardized Approach
2. Default minimum Half-yearly frequency
3. Capital Adequacy
4. Credit Risk: General Disclosures for All Banks
(A) P-2, Q-3, R-1, S-4
(B) P-3, Q-4, R-1, S-2
(C) P-4, Q-1, R-2, S-3
(D) P-1, Q-2, R-4, S-3

Oct/Nov 2006

34. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct option from the following:
Assertion (A): Banks are required to maintain a prominent direct link to their 'Regulatory Disclosures Section' on the home page of their website.
Reason (R): The relevance and benefit of Pillar 3 disclosures are diminished if market participants face significant challenges in finding the information.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2017

35. Consider the following statements regarding the website disclosures:
I The direct link to a bank's 'Regulatory Disclosures Section' must be prominently provided on the home page.
II This requirement ensures that the relevance of Pillar 3 disclosures is not diminished by the challenge of finding them.
Which of the above statement(s) is/are correct?
(A) Only Statement (I) is correct.
(B) Only Statement (II) is correct.
(C) Both Statements (I) and (II) are correct.
(D) Neither Statement (I) nor (II) is correct.

Oct/Nov 2005

36. Read the following scenario regarding Alpha Bank and answer the question:
Following the regulatory review, a financial penalty was formally imposed on Alpha Bank for its disclosure failures. To comply with market discipline mechanisms and ensure transparency, where must Alpha Bank disclose this financial penalty?
(A) In its annual report and balance sheet.
(B) Exclusively in a confidential letter to large depositors.
(C) Only in the internal management assessment reports.
(D) In the national accounting standards framework document.

May/June 2008

37. Match the regulatory pillars or concepts in List I with their primary focus area in List II.
List I: (Regulatory Concept)
P. Pillar 1
Q. Pillar 2
R. Pillar 3
S. Accounting Standards
List II: (Primary Focus Area)
1. Market discipline and disclosure requirements
2. Minimum capital requirements
3. Supervisory review process
4. Broader scope of financial reporting
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-3, S-1

Oct/Nov 2013

38. Consider the following statements regarding materiality:
I Information is considered material if its misstatement could change a user's economic decision.
II The regulator does not consider it necessary to set specific thresholds for all disclosures due to the utility of the user test.
III Materiality thresholds have been prescribed for certain limited disclosures to promote greater comparability.
IV Banks are strictly prohibited from making disclosures below the specified materiality thresholds.
Which of the above statement(s) is/are correct?
(A) Statements (I), (II), and (III)
(B) Statements (II), (III), and (IV)
(C) Statements (I), (III), and (IV)
(D) Statements (I), (II), and (IV)

May/June 2015

39. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct option from the following:

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Assertion (A): Uninsured depositors will demand higher interest rates when a bank takes on more risk.
Reason (R): Uninsured depositors face the potential loss of their money if the bank fails and therefore require compensation for greater risk.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2024

40. Identify the incorrectly matched pair.
(A) Proprietary systems : Protection balances with meaningful disclosure
(B) Statutory and voluntary : Two dimensions of disclosures
(C) Disclosure policy : Formal document approved by the Board of Directors
(D) Multiple business lines : Decreases the opacity of bank balance sheets

May/June 2010

41. Read the following scenario regarding Beta Bank's reporting and answer the question:
Since Beta Bank's MD&A will not be externally audited, what specific action must management take to satisfy the validation requirement for this supplementary material?
(A) They must submit the MD&A to a rival banking institution for an independent peer review process.
(B) They must subject the MD&A to sufficient scrutiny, such as through internal control assessments.
(C) They must request a temporary waiver from the Basel Committee regarding the validation requirements.
(D) They must publish a formal disclaimer stating that the supplementary information is entirely unverified.

Oct/Nov 2021

42. Match the disclosure-related terms in List I with their associated requirements in List II.
List I: (Disclosure Term)
P. Regulatory Disclosures Section
Q. Financial Penalties
R. Validation Regime
S. Intricate ownership hierarchies
List II: (Associated Requirement/Result)
1. Increases the complexity of processing information
2. Must be disclosed in the annual report and balance sheet
3. Ensures appropriate verification of information
4. Must be easily accessible via a prominent home page link
(A) P-4, Q-2, R-3, S-1
(B) P-2, Q-1, R-4, S-3
(C) P-3, Q-4, R-1, S-2
(D) P-1, Q-3, R-2, S-4

May/June 2023

43. Consider the following statements detailing the complexity of modern financial institutions:
I The rapid development of new financial instruments has decreased the opacity of bank balance sheets.
II Financial institutions are currently structured as intricate ownership hierarchies.
III Banks operate multiple business lines ranging from insurance to investment management.
IV A substantial portion of bank income is now received from noninterest activities.
Which of the above statement(s) is/are correct?
(A) Statements (I), (II), and (III)
(B) Statements (I), (III), and (IV)
(C) Statements (II), (III), and (IV)
(D) Statements (I), (II), and (IV)

Oct/Nov 2008

44. Consider the following statements regarding market discipline incentives:
I Market participants must have both the means to monitor and the ability to impose discipline on financial institutions.
II Because uninsured depositors can lose money when a bank fails, they will demand higher rates for greater risks.
III Rating agencies have no influence over a financial institution's behavior under the

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I Banks must have a formal disclosure policy approved by the Board of Directors.
II The policy must address internal controls over the disclosure process.
III All Pillar 3 disclosures must be audited by an external auditor prior to publication.
IV Disclosures must be made concurrent with the publication of financial statements.

Which of the above statement(s) is/are correct?
(A) Statements (I), (II), and (III)
(B) Statements (I), (II), and (IV)
(C) Statements (II), (III), and (IV)
(D) Statements (I), (III), and (IV)

Oct/Nov 2017

56. Match the entities in List I with their roles or actions in List II.

List I: (Entity)
P. Senior Management and Board
Q. Large Depositors and Shareholders
R. Basel Committee on Banking Supervision (BCBS)
S. External Auditor

List II: (Role/Action)
1. Taken considerable efforts to prevent conflict with accounting standards
2. Assess and manage the risks of the bank
3. Not strictly required for Pillar 3 disclosures unless specified
4. Have natural incentives to monitor banks due to money at stake

(A) P-2, Q-4, R-1, S-3
(B) P-1, Q-3, R-4, S-2
(C) P-4, Q-1, R-3, S-2
(D) P-3, Q-2, R-1, S-4

May/June 2005

57. Read the following scenario regarding a bank's operations and answer the question:

Alpha Bank failed to comply with the prescribed Pillar 3 disclosure requirements for the current financial year. Management insists that since they met all capital adequacy ratios, they face no repercussions. According to regulatory guidelines, what is the immediate consequence Alpha Bank is most likely to attract for this specific non-compliance?

(A) A financial penalty imposed by the regulator.
(B) Immediate liquidation of the bank's non-banking assets.
(C) An automatic increase in the minimum capital requirements under Pillar 1.
(D) Mandatory replacement of the Board of Directors.

Oct/Nov 2012

58. Consider the following statements regarding the consequences of non-disclosure:

I A direct sanction of not being allowed to apply a lower risk weighting occurs if disclosure is a qualifying criterion under Pillar 1.
II Direct additional capital requirements are generally the intended response to any standard non-disclosure.

Which of the above statement(s) is/are correct?
(A) Only Statement (I) is correct.
(B) Only Statement (II) is correct.
(C) Both Statements (I) and (II) are correct.
(D) Neither Statement (I) nor (II) is correct.

May/June 2019

59. Consider the following statements regarding information access and transparency:

I Market participants must have access to relevant and timely information.
II Stringent disclosure rules decrease market transparency.
III Independent outside audits allow for greater discipline by market participants.
IV The availability of credit ratings increases transparency.
V Reliable financial information is crucial for debtholders to monitor investments.

Which of the above statement(s) is/are correct?
(A) Statements (I), (III), (IV), and (V)
(B) Statements (I), (II), (III), and (IV)
(C) Statements (II), (III), (IV), and (V)
(D) Statements (I), (II), (IV), and (V)

Oct/Nov 2020

60. Consider the following statements regarding accounting and regulatory disclosures:

I Pillar 3 disclosure framework conflicts significantly with requirements under accounting standards.
II The regulator may consider future modifications to disclosures based on industry developments.

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(A) Statements (I), (II), (III), and (V)
(B) Statements (II), (III), (IV), and (V)
(C) Statements (I), (II), (III), and (IV)
(D) Statements (I), (II), (IV), and (V)

Oct/Nov 2014

50. Consider the following statements regarding proprietary and confidential information:

I Sharing proprietary information with competitors would undermine a bank's competitive position.
II Information about a bank's customers is typically provided under the terms of a legal agreement.
III Banks are forced to reveal all proprietary methodologies irrespective of their impact on competitive positioning.

Which of the above statement(s) is/are correct?

(A) Statements (I) and (II)
(B) Statements (II) and (III)
(C) Statements (I) and (III)
(D) All Statements (I), (II), and (III)

May/June 2009

51. Read the following scenario regarding Beta Bank and answer the question:

Beta Bank publishes its financial results on a half-yearly basis. It includes supplementary material in the form of a Management's Discussion and Analysis (MD&A) report. The compliance officer argues that the entire MD&A report must undergo an external audit before publication. Is the compliance officer correct according to the guidelines?

(A) Yes, because all Pillar 3 disclosures are required to be audited by an independent external auditor.
(B) Yes, but only in instances where the MD&A report contains highly sensitive proprietary information.
(C) No, because supplementary materials are strictly prohibited from containing any Pillar 3 disclosures.
(D) No, external audits are not required if sufficient internal scrutiny and control assessments are applied.

Oct/Nov 2011

52. Identify the correctly matched pair regarding disclosure requirements.

(A) Table DF-2 : Disclosed exclusively on an annual basis
(B) Pillar 1 : Focuses purely on market discipline
(C) Confidential Information : Always shared with competitors
(D) User Test : Qualitative judgment of materiality

May/June 2016

53. Consider the following statements regarding validation:

I If material is published in a stand-alone report outside a validation regime, management is not responsible for verifying the information.
II Supplementary material such as Management's Discussion and Analysis should be subjected to internal control assessments.

Which of the above statement(s) is/are correct?

(A) Only Statement (I) is correct.
(B) Only Statement (II) is correct.
(C) Both Statements (I) and (II) are correct.
(D) Neither Statement (I) nor (II) is correct.

Oct/Nov 2009

54. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct option from the following:

Assertion (A): It is generally not intended that direct additional capital requirements would be a response to non-disclosure under Pillar 3.
Reason (R): The financial penalties imposed by the regulator for non-disclosure must be disclosed by the bank in its annual report and balance sheet.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2021

55. Consider the following statements regarding general disclosure principles:

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must Gamma Bank publish on a quarterly basis?

(A) Details regarding the bank's proprietary investment systems.
(B) The comprehensive Management's Discussion and Analysis.
(C) The Board's formal disclosure policy document.
(D) Table DF-3: Credit Risk: General Disclosures for All Banks.

May/June 2020

67. Read the following scenario regarding Epsilon Bank and answer the question:
Epsilon Bank operates multiple business lines, ranging from insurance to investment management, heavily reliant on noninterest income. Recently, the bank acquired high-risk derivatives. Upon learning this, large uninsured institutional investors began offloading Epsilon Bank's debt, causing the debt's market yield (rates) to spike. This scenario perfectly illustrates the functioning of:

(A) Pillar 1 minimum capital requirements
(B) The external auditor's validation mandate
(C) The statutory conflict with international accounting standards
(D) Market discipline exerting pressure on a financial institution

Oct/Nov 2006

68. Read the following scenario regarding Delta Bank's customer data and answer the question:
In addition to its algorithms, Delta Bank possesses vast amounts of customer data obtained under counterparty relationship agreements. Why is Delta Bank restricted from publicly revealing this specific customer information in its Pillar 3 disclosures?

(A) It is classified as confidential information provided under legal terms.
(B) It fails to meet the quantitative materiality threshold.
(C) It conflicts with the broader accounting requirements.
(D) It would trigger direct additional capital requirements.

May/June 2017

69. Read the following scenario regarding Gamma Bank's table requirements and answer the question:
The compliance team at Gamma Bank is also reviewing Table DF-4. To avoid regulatory penalties and align with the guidelines, at what frequency must Gamma Bank ensure Table DF-4 is disclosed?

(A) Annually
(B) Half-yearly
(C) Quarterly
(D) Monthly

Oct/Nov 2005

70. Read the following scenario regarding the regulator's response to Epsilon Bank and answer the question:
The central bank (regulator) observes the sudden spike in Epsilon Bank's debt yields driven by the uninsured investors. According to the principles of market discipline, how should the regulator utilize this market data?

(A) Ignore it, as market prices are irrelevant to supervisory reviews.
(B) Use the higher market prices as a valuable signal of greater risk-taking to discipline the bank.
(C) Mandate the investors to purchase more debt to stabilize the market price.
(D) Automatically lower Epsilon Bank's capital requirements to ease financial stress.

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III Accounting standards are broader in scope compared to the narrower capital adequacy focus of Pillar 3.

Which of the above statement(s) is/are correct?

(A) Statements (I) and (II)
(B) Statements (II) and (III)
(C) Statements (I) and (III)
(D) All Statements (I), (II), and (III)

May/June 2007

61. Read the following scenario regarding Delta Bank's reporting decisions and answer the question:
For its half-yearly disclosures, Delta Bank decides to omit a minor operational loss event from its public report. Management concludes that this omission will not influence the economic decisions of any user relying on the information. This decision is an application of:
(A) The Validation Regime
(B) The Specific Methodology Exemption
(C) The Materiality Concept and User Test
(D) The Interaction with Accounting Disclosures

Oct/Nov 2010

62. Read the following scenario regarding Gamma Bank's table scheduling and answer the question:
Gamma Bank mistakenly schedules the publication of Table DF-2 for a half-yearly release. What specific information does Table DF-2 contain that mandates a more frequent quarterly disclosure?
(A) Capital Adequacy
(B) Operational Risk Methodologies
(C) Liquidity Coverage Ratios
(D) Confidential Customer Data

May/June 2024

63. Read the following scenario regarding Beta Bank's disclosures and answer the question:
Due to formatting constraints, Beta Bank finds it operationally inconvenient to include the detailed Pillar 3 disclosure tables within its printed financial results. To remain compliant, what must Beta Bank do?
(A) Delay the publication of the financial results until all formatting and printing issues are resolved.
(B) Exclude the tables from the current period and provide double the disclosures in the next reporting period.
(C) Provide a direct link in the financial results to the disclosures available on the bank's website.
(D) Send physical copies of the data tables to all uninsured institutional and retail depositors via mail.

Oct/Nov 2022

64. Read the following scenario regarding Epsilon Bank's balance sheet opacity and answer the question:
In the case of Epsilon Bank, the market participants found it initially difficult to detect the high-risk derivatives on the balance sheet. According to the structural features discussed, what most likely contributed to this opacity?
(A) Its compliance with half-yearly disclosure frequencies.
(B) Its maintenance of a 'Regulatory Disclosures Section' on its website.
(C) Its intricate ownership hierarchies and multiple complex business lines.
(D) Its strict adherence to the materiality user test.

May/June 2014

65. Read the following scenario regarding Delta Bank and answer the question:
Delta Bank has developed a highly advanced, proprietary algorithm for assessing credit risk, giving it a significant competitive advantage. The regulator requires detailed risk disclosures. Delta Bank is concerned that revealing the specific parameter estimates of this algorithm would allow competitors to replicate it. Under which principle can Delta Bank restrict the release of these specific parameter estimates?
(A) The Materiality Benchmark
(B) Protection of Proprietary Information
(C) The Supervisory Review Exemption
(D) The General Intervention Measure

Oct/Nov 2025

66. Read the following scenario regarding Gamma Bank and answer the question:
Gamma Bank is updating its disclosure calendar. The regulatory team notes that while most Pillar 3 disclosures are required half-yearly, certain tables must be published quarterly. Which of the following disclosures

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8. (B) Pillar 3 disclosures should be made concurrent with the publication of financial results or statements.
Pillar 3 disclosures should ideally be published concurrently with the bank's financial results or statements. This timing ensures that market participants have access to a comprehensive view of the institution's performance and risk exposure at the same time. If simultaneous publication is not feasible, banks must provide clear links to where the regulatory information can be found on their websites.

9. (B) The reduction of business lines exclusively to simple retail lending operations.
Market participants face challenges in processing information due to the complexity of modern banking. Factors such as rapid financial innovation, intricate ownership hierarchies, and high levels of noninterest income make evaluating a bank's true risk profile difficult. Conversely, focusing solely on simple retail lending operations would actually simplify the balance sheet, making it easier for stakeholders to understand and monitor.

10. (C) They have money at stake and can lose their funds if the bank fails.
Uninsured depositors have a natural incentive to monitor a bank's risk-taking behavior because their funds are not protected by government guarantees. If a bank fails, these depositors face the very real possibility of losing their money. This financial exposure motivates them to closely watch the bank's activities and demand higher interest rates if they perceive that the risk increases.

11. (B) 1, 2, 3, 4
Compliance with general disclosure principles begins with the Board of Directors approving a formal disclosure policy. Following this, management implements necessary internal controls to assess the appropriateness of the data. The disclosures must then be validated through verification processes to ensure accuracy. Finally, the information is published on the bank's website or alongside its financial results for public access.

12. (C) Pillar 3
The Basel capital regulations are structured into three pillars to ensure financial stability. Pillar 1 deals with minimum capital requirements, while Pillar 2 focuses on the supervisory review process. Pillar 3 is dedicated to market discipline, using disclosure requirements to provide transparency. This allows market participants to assess a bank's capital adequacy and risk position, complementing the other two pillars.

NODIA

13. (A) Direct additional capital requirements are the standard and automatic response to any non-disclosure.
While non-compliance with disclosure requirements is serious, direct additional capital requirements are not the standard or automatic response. Instead, regulators typically impose financial penalties, which the bank must then disclose in its annual reports. Furthermore, failing to provide required information can damage a bank's reputation and hinder its ability to use certain advanced risk-weighting methodologies allowed under the framework.

14. (C) Bank disclosures should be consistent with how senior management and the Board assess and manage risks.
Pillar 3 disclosures are intended to be consistent with the way senior management and the Board of Directors assess and manage risk. This alignment ensures that the information shared with the public reflects the actual internal risk profile and governance of the institution. By providing a clear view of management's perspective, disclosures help market participants better understand the bank's strategy.

15. (D) It acts as a qualitative benchmark to judge whether a user would consider an item material.
The user test functions as a qualitative benchmark within the materiality framework to determine if an item should be disclosed. It asks whether the omission or misstatement of information could influence the economic decisions of a user. This approach ensures that banks provide relevant information that stakeholders actually need for evaluation, rather than relying solely on rigid and arbitrary numerical thresholds.

ANSWERS

1. (D) On a half-yearly basis
Pillar 3 disclosures aim to promote market discipline by providing information on a bank's risk profile. While some specific data tables require quarterly reporting to capture high-frequency changes, the standard regulatory framework sets the minimum frequency for general disclosures at a half-yearly basis. This frequency ensures that stakeholders receive regular updates on capital adequacy and risk management.

2. (C) Pillar 3 disclosures require mandatory auditing by an external auditor in all standard circumstances.
The validation of Pillar 3 disclosures does not typically mandate external auditing for all materials. While information in annual financial statements undergoes external audits, other components like management reports require sufficient internal scrutiny and verification. Management is responsible for ensuring that the disclosed data is accurate and consistent with audited statements to maintain transparency and regulatory compliance.

3. (C) Information provided under the terms of a legal agreement or counterparty relationship.
Confidential information in banking refers to details provided under the terms of a legal agreement or a counterparty relationship. Disclosing such information publicly could violate legal obligations or damage trust between the institution and its clients. Protecting this data is essential while ensuring that enough material information is still shared with the market to facilitate effective and informed monitoring.

4. (C) To ensure the investing community is kept informed, acting as a proactive risk management tool.
Banks often choose to disclose information beyond statutory requirements to keep the investing community informed. Proactive transparency serves as a risk management tool, building market confidence and reputation. By providing additional insights into their risk profiles and mitigation strategies, institutions help market participants make better decisions, which can lead to more stable funding costs and stronger market discipline.

5. (B) Management must ensure that appropriate verification of the information takes place internally.
When Pillar 3 material is published in a stand-alone report rather than within audited financial statements, management must ensure appropriate internal verification. This internal scrutiny is necessary to confirm that the disclosed information is accurate and reliable. While external audits are common for financial statements, the responsibility for the integrity of supplementary stand-alone reports remains with the bank's leadership.

6. (B) It makes risk-taking costlier as uninsured depositors demand higher rates when a bank takes on more risk.
Market discipline impacts a financial institution's risk-taking by making it more expensive. When a bank engages in excessive risk, market participants like uninsured depositors recognize the increased danger to their funds. Consequently, they demand higher interest rates to compensate for the higher risk. This mechanism provides a financial incentive for the bank to maintain a more conservative and prudent risk profile.

7. (B) The ability of market participants to influence a financial institution's behavior through monitoring its risk profile.
Market discipline refers to the process where market participants influence a bank's behavior by monitoring its risk profile. By analyzing disclosed information, stakeholders such as creditors and shareholders can reward or penalize the bank based on its risk management. This transparency encourages banks to operate soundly, complementing regulatory supervision by using market signals to discourage imprudent activities and maintain stability.

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24. (D) Fully insured retail depositors
Effective market discipline relies on participants having strong incentives to monitor banks. Shareholders, large uninsured depositors, and unsecured creditors all have their own money at stake and face potential losses if the bank fails. However, fully insured retail depositors lack these incentives because their funds are protected by government guarantees, meaning they are less likely to actively monitor risk.

25. (B) Stringent disclosure rules and independent audits decrease transparency in financial markets.
Market discipline was introduced as the third pillar of the Basel regulations to enhance financial stability. Contrary to the idea that rules decrease transparency, stringent disclosure requirements and independent audits are designed to increase it. Reliable information is essential for uninsured debtholders to monitor their investments effectively, and regulators use market signals as a tool to identify and address excessive risk-taking.

26. (D) When its omission or misstatement could change or influence the assessment or decision of a user.
Financial information is regarded as material based on the impact it has on the users of that information. Specifically, it is material if its omission or misstatement has the potential to change or influence the economic decisions or assessments of a person relying on that data. This concept aligns with international accounting standards and ensures that disclosures remain relevant and useful.

27. (A) Provide a direct link in the financial results to the disclosures found on the bank's website.
If a bank finds it operationally difficult to include all Pillar 3 tables within its printed financial results, the prescribed alternative is to provide a direct link to the disclosures on its website. This link must be clearly stated within the financial statements. This approach ensures that the information remains accessible to all stakeholders without imposing unnecessary physical printing burdens.

28. (A) They increase the complexity and opacity of bank balance sheets for market participants.
The rapid development of new and complex financial instruments significantly impacts market discipline by increasing the opacity of bank balance sheets. These instruments can be difficult for market participants to value and understand, making it harder to assess a bank's true risk exposure. Consequently, this complexity heightens the need for clear, detailed, and frequent disclosures to maintain effective transparency.

29. (C) Table DF-5: Operational Risk: General Disclosures for All Banks
While the default frequency for most Pillar 3 disclosures is half-yearly, certain critical tables must be updated quarterly. These include Table DF-2 for capital adequacy and Tables DF-3 and DF-4 for general and standardized credit risk disclosures. However, Table DF-5, which pertains to operational risk disclosures, is not among those specifically required to be published on a quarterly basis.

30. (D) The narrow focus of Pillar 3 on capital adequacy does not conflict with broader accounting requirements.
Pillar 3 disclosures are designed to focus narrowly on capital adequacy and related risk exposures within the regulatory framework. Because of this specific focus, they generally do not conflict with the broader financial reporting requirements of international or national accounting standards. The Basel Committee made efforts to ensure that regulatory disclosures complement, rather than override, the existing accounting information.

31. (C) High market prices for debt : Valuable signal of greater risk-taking
In market dynamics, low market prices for debt, or high yields, serve as a valuable signal of greater risk-taking by a bank. When investors perceive higher risk, they demand higher returns, which is reflected in market data. This signal allows regulators to identify potential issues early. Conversely, uninsured lenders have strong incentives to monitor, and stand-alone reports still require verification.

NODIA

16. (A) Data on systems or products whose public release would damage a bank's competitive standing.
Proprietary information includes data regarding systems, products, or internal methodologies whose public release would likely damage a bank's competitive standing. This information often involves unique intellectual property or strategic business models. Regulatory frameworks allow banks to protect such details to maintain their market position, provided they still offer enough general information to satisfy transparency requirements and inform market participants effectively.

17. (A) Classified as proprietary information that would undermine competitive position.
Banks are generally required to provide comprehensive risk disclosures; however, an exception is made for proprietary information. If disclosing specific details would undermine a bank's competitive position or reveal unique internal systems, the bank can omit those specifics. In such cases, the bank must still provide more general information about the subject and explain why the specific details were not disclosed.

18. (A) On the home page of the bank's website
To ensure easy access for all market participants, banks are required to provide a prominent and direct link to their 'Regulatory Disclosures Section' on the home page of their website. Making this information highly visible prevents stakeholders from facing significant challenges when searching for regulatory data. This accessibility is crucial for the effectiveness of Pillar 3 in promoting market transparency.

19. (D) All banks are required to submit Table DF-2 on a half-yearly basis along with other standard tables.
General disclosure principles require transparency through both statutory and voluntary means. While most Pillar 3 disclosures are required on a half-yearly basis, specific tables such as Table DF-2 regarding capital adequacy must be disclosed more frequently, specifically on a quarterly basis. This higher frequency is necessary because capital levels can change rapidly, and market participants need timely updates to monitor risk.

20. (A) Thresholds are prescribed for limited disclosures to facilitate a smooth transition and greater comparability.
Materiality thresholds are prescribed for certain limited disclosures to facilitate a smooth transition and ensure greater comparability across different financial institutions. While the qualitative user test is a primary guide, these specific thresholds help standardize the reporting of critical data. Banks must balance these requirements with the need to provide all information that could influence the economic decisions of stakeholders.

21. (A) 2, 1, 4, 3
The mechanism of market discipline typically begins when a bank takes on excessive risk. This action puts the funds of uninsured depositors at potential risk of loss. In response, these depositors demand higher interest rates, which increases the bank's cost of funding. Regulators then observe these market signals, such as higher yields, and use them to discipline the institution.

22. (B) The Board of Directors
The Board of Directors is ultimately responsible for approving a bank's formal disclosure policy. This policy outlines how the institution will communicate its risk profile and capital adequacy to the public. By requiring Board-level approval, the regulatory framework ensures that high-level governance is applied to transparency, making certain that the disclosure process is robust, consistent, and aligned with overall strategy.

23. (D) The bank is prohibited from applying lower risk weightings or specific methodologies.
If a bank fails to make a disclosure that is a qualifying criterion for a specific Pillar 1 methodology, the regulator may impose a direct sanction. Specifically, the bank may be prohibited from applying lower risk weightings or using that specific methodology for calculating its capital requirements. This penalty directly links the quality of public transparency with the bank's regulatory capital burden.

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market discipline framework.

Which of the above statement(s) is/are correct?

(A) Statements (I) and (II)
(B) Statements (II) and (III)
(C) Statements (I) and (III)
(D) All Statements (I), (II), and (III)

May/June 2011

45. Read the following scenario regarding Alpha Bank and answer the question:

During the subsequent quarter, Alpha Bank attempted to apply a specific methodology to achieve lower risk weightings under Pillar 1. However, the regulator denied this application. Based on the regulatory framework, what is the most likely justification for the regulator's direct sanction?

(A) Alpha Bank's failure to ensure its Pillar 3 disclosures were audited by a third-party external firm.
(B) Alpha Bank's unilateral decision to classify its standard customer data as protected confidential information.
(C) Alpha Bank's failure to meet the qualifying disclosure criteria required to apply that specific methodology.
(D) Alpha Bank's recent transition to an intricate ownership hierarchy that complicates regulatory reporting.

Oct/Nov 2016

46. Match the type of information in List I with its characteristic in List II.

List I: (Information Type)
P. Proprietary Information
Q. Confidential Information
R. Material Information
S. Supplementary Material

List II: (Characteristic)
1. Omission could influence economic decisions
2. Requires sufficient internal scrutiny (e.g., MD&A)
3. Would render a bank's investment less valuable if shared
4. Provided under the terms of a legal agreement

(A) P-2, Q-3, R-1, S-4
(B) P-3, Q-4, R-1, S-2
(C) P-1, Q-2, R-4, S-3
(D) P-4, Q-1, R-3, S-2

May/June 2025

47. In the following question, a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct option from the following:

Assertion (A): Pillar 3 disclosures are not required to be audited by an external auditor unless specifically mandated.

Reason (R): The information in the annual financial statements is generally already audited, and supplementary material is subjected to sufficient internal scrutiny.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2019

48. Identify the incorrectly matched pair.

(A) Non-compliance penalty : Disclosed in the balance sheet
(B) Pillar 3 disclosures : Must always be audited by an external auditor
(C) Materiality concept : Consistent with International Accounting Standards
(D) Table DF-3 : Disclosed at least on a quarterly basis

May/June 2012

49. Consider the following statements regarding disclosure frequency and mechanisms:

I Pillar 3 disclosures are required at least on a half-yearly basis by default.
II Table DF-2 must be disclosed at least on a quarterly basis.
III Table DF-3 must be disclosed at least on a quarterly basis.
IV Table DF-4 must be disclosed at least on a quarterly basis.
V Disclosures are required only if the financial statements have been externally audited.

Which of the above statement(s) is/are correct?

NODIA

32. (B) Statements (I), (II), (IV), and (V)
Market discipline, the third pillar of Basel regulations, relies on participants like shareholders and rating agencies to monitor banks. It functions as a systemic force to improve risk management performance and requires disclosures that align with senior management's risk assessments. Importantly, it aims to make risk-taking costlier, not cheaper, for financial institutions, thereby discouraging excessive or imprudent risk-taking behavior.

33. (B) P-3, Q-4, R-1, S-2
Pillar 3 disclosure tables are categorized by subject. Table DF-2 specifically covers capital adequacy, while Table DF-3 provides general credit risk disclosures for all banks. Table DF-4 focuses on credit risk for portfolios under the standardized approach. Unless otherwise specified, the default minimum frequency for other Pillar 3 disclosures in the framework is generally on a half-yearly basis.

34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
It is true that banks must maintain a prominent direct link to their 'Regulatory Disclosures Section' on their website's home page. The reason is that the benefit of Pillar 3 disclosures depends on the ease with which market participants can find the information. If finding the data is too challenging, the effectiveness of market discipline through transparency is significantly reduced.

35. (C) Both Statements (I) and (II) are correct.
Banks are required to provide a direct and prominent link to their regulatory disclosures on their home page to ensure information is easily accessible. This requirement is vital because the value of Pillar 3 disclosures is diminished if market participants struggle to locate them. Both statements correctly reflect the importance of accessibility in fostering transparency and effective market discipline mechanisms.

36. (A) In its annual report and balance sheet.
If a bank is fined by a regulator for failing to meet disclosure requirements, it is mandated to disclose this financial penalty in its annual report and balance sheet. This requirement ensures that shareholders and other market participants are aware of the regulatory breach. Such transparency is a core part of the market discipline mechanism, holding the bank accountable.

37. (A) P-2, Q-3, R-1, S-4
The regulatory framework is divided into distinct focus areas. Pillar 1 is concerned with establishing minimum capital requirements for banks. Pillar 2 involves the supervisory review process conducted by regulators. Pillar 3 focuses on market discipline through mandatory disclosure requirements. Meanwhile, general accounting standards provide a broader scope of financial reporting beyond the specific regulatory focus on capital.

38. (A) Statements (I), (II), and (III)
Information is material if its misstatement could influence a user's economic decisions. Regulators rely on the qualitative user test and generally do not set thresholds for all disclosures. However, specific thresholds are prescribed for limited disclosures to improve comparability across banks. Contrary to the fourth statement, banks are not prohibited from disclosing information that falls below materiality thresholds if they choose.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Uninsured depositors demand higher interest rates from banks they perceive as taking on more risk. This is because these depositors face a real potential for financial loss if the bank fails, as their funds are not protected. The demand for higher compensation serves as a direct cost to the bank, illustrating how market participants can impose discipline through pricing.

40. (D) Multiple business lines : Decreases the opacity of bank balance sheets
A formal disclosure policy must be approved by the Board, and disclosures have both statutory and voluntary dimensions. Proprietary systems also require a balance between protection and disclosure. However, the claim that multiple business lines decrease opacity is incorrect; in reality, having diverse operations like insurance

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May/June 2008

28. Why is the credit demand in a structurally transforming economy like India expected to expand faster than GDP growth?
(A) Due to the shifting from services to manufacturing, infrastructure investments, and financial inclusion programs
(B) Due to a shift from manufacturing to services where credit intensity and industry borrowing needs are lower
(C) Due to strict tightening of credit standards by banks during economic booms to mitigate future losses
(D) Due to the reduction in non-performing assets across the banking sector through robust recovery mechanisms

Oct/Nov 2025

29. Which of the following is NOT considered an element subject to the restriction on distributions under the capital conservation buffer framework?
(A) Periodic dividend payments
(B) Common stock share buybacks
(C) Payments which do not result in depletion of Common Equity Tier 1 capital
(D) Discretionary staff bonus payments

May/June 2022

30. Which statement is correct regarding the methodology for identifying Domestic Systemically Important Banks (D-SIBs)?
(A) The systemic importance of all banks, regardless of size, must be computed annually
(B) Foreign banks in India are automatically excluded from the sample due to their smaller balance sheet size
(C) The methodology adopted gives equal weight to all indicators including size, interconnectedness, substitutability, and complexity
(D) Banks having a size beyond 2% of GDP will be selected in the sample

Oct/Nov 2016

31. Identify the correct pair matching the Basel III Liquidity Return with its reporting frequency.
(A) Statement on Liquidity Coverage Ratio (BLR-1) — Quarterly
(B) Statement of Available Unencumbered Assets (BLR-3) — Quarterly
(C) LCR by Significant Currency (BLR-4) — Monthly
(D) Statement of Funding Concentration (BLR-2) — Quarterly

May/June 2017

32. Consider the following recognized features of High Quality Liquid Assets (HQLA) in the stock of liquid assets:
I Low risk
II Ease and certainty of valuation
III Low correlation with risky assets
IV Listed on a well-established exchange
V Flight to quality during systemic crises
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (V)
(B) (I), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2009

33. Match the items in List I with the items in List II and select the correct option.
List I: (HQLA Categories)
P. Cash including cash reserves in excess of required CRR
Q. Marketable securities representing claims on sovereigns assigned a 20% risk weight
R. Common Equity Shares included in NSE CNX Nifty index
S. Corporate bonds rated AA- or above by an Eligible Credit Rating Agency
List II: (Minimum Haircuts)
1. 0% Haircut
2. 15% Haircut
3. 50% Haircut
4. 100% Haircut
(A) P-2, Q-1, R-4, S-3
(B) P-1, Q-2, R-3, S-2
(C) P-1, Q-3, R-2, S-4
(D) P-3, Q-2, R-1, S-4

May/June 2020

34. Read the given assertion and reason and select the most appropriate option.
Assertion (A): The Net Stable Funding Ratio (NSFR) limits overreliance on short-term wholesale funding and encourages better assessment of funding risk.
Reason (R): A sustainable funding structure reduces the probability of erosion of a bank's

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must be published quarterly to provide timely updates on capital and credit risk. Statement V is incorrect because disclosure requirements are not contingent solely on whether financial statements have been externally audited; they are a separate regulatory obligation intended to promote market transparency.

50. (A) Statements (I) and (II)
Proprietary information is protected because sharing it could damage a bank's competitive position. Similarly, customer information is often confidential, provided under legal agreements that prevent public disclosure. Statement III is incorrect because banks are not forced to reveal all proprietary methodologies; the framework allows them to provide general information instead if specific details would harm their competitiveness.

51. (D) No, external audits are not required if sufficient internal scrutiny and control assessments are applied.
The compliance officer is incorrect because external audits are not mandatory for all parts of the Pillar 3 disclosures. For supplementary material like an MD&A report, the requirement is that management must ensure sufficient internal scrutiny and verification. As long as internal control assessments are applied to verify the information, a formal third-party audit is not strictly necessary.

52. (D) User Test : Qualitative judgment of materiality
Table DF-2 must be disclosed quarterly, not just annually, and Pillar 1 focuses on capital requirements, not just market discipline. Confidential information is protected, not shared with competitors. The user test is correctly identified as a qualitative judgment of materiality, used to determine if the omission of information would influence the economic decisions of a person relying on it.

53. (B) Only Statement (II) is correct.
Management is always responsible for ensuring the accuracy of disclosed information, even if it is published in a stand-alone report outside a standard validation regime. Therefore, Statement I is incorrect. Statement II is correct, as supplementary materials like Management's Discussion and Analysis (MD&A) should be subjected to internal control assessments to maintain the integrity of the information.

54. (B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
It is true that additional capital requirements are generally not the intended response to non-disclosure, and it is also true that financial penalties for non-disclosure must be reported in the bank's balance sheet. However, the requirement to disclose penalties does not explain why capital requirements are not used as a sanction; these are two separate regulatory enforcement mechanisms.

55. (B) Statements (I), (II), and (IV)
Banks must have a formal disclosure policy approved by the Board of Directors that addresses internal controls. Disclosures should also be made concurrent with the publication of financial statements. However, Statement III is incorrect because there is no universal requirement that all Pillar 3 disclosures must be externally audited; internal verification is often acceptable for various supplementary regulatory materials.

56. (A) P-2, Q-4, R-1, S-3
Senior management and the Board are responsible for assessing and managing risks. Large depositors and shareholders have natural incentives to monitor banks due to their financial stake. The Basel Committee (BCBS) has worked to prevent conflicts between disclosures and accounting standards. Finally, external auditors are not strictly required to audit all Pillar 3 disclosures unless specifically mandated.

57. (A) A financial penalty imposed by the regulator.
If a bank fails to comply with prescribed Pillar 3 disclosure requirements, the immediate and most likely regulatory consequence is the imposition of a financial penalty. While capital adequacy ratios may be met, transparency is a separate requirement. The bank must also disclose this penalty in its financial statements, which alerts the market to its failure to maintain transparency.

NODIA

and investment management alongside banking actually increases the complexity and opacity of balance sheets.

41. (B) They must subject the MD&A to sufficient scrutiny, such as through internal control assessments.
Supplementary material like Management's Discussion and Analysis is often not subject to a formal external audit. Therefore, management must ensure that this information is subjected to sufficient internal scrutiny and verification. This is typically achieved through robust internal control assessments. This process ensures the reliability of the disclosed data, even in the absence of a third-party auditor's certification.

42. (A) P-4, Q-2, R-3, S-1
Regulatory disclosure sections must be accessible via a prominent home page link. Financial penalties for non-disclosure must be recorded in the annual report and balance sheet. A validation regime ensures that all information is appropriately verified, while intricate ownership hierarchies are identified as factors that increase the complexity and difficulty of processing bank information for market participants.

43. (C) Statements (II), (III), and (IV)
Modern financial institutions are increasingly complex due to their structure as intricate ownership hierarchies and their operation across multiple business lines, such as insurance and investment management. Additionally, a significant part of their income now comes from noninterest activities. While these factors increase balance sheet opacity, the development of new financial instruments has actually increased, not decreased, this opacity.

44. (A) Statements (I) and (II)
Market discipline requires that participants have both the means to monitor and the ability to impose discipline on banks. Uninsured depositors, who risk losing their money, provide this discipline by demanding higher interest rates for higher risks. Statement III is incorrect because rating agencies are explicitly identified as participants that do help influence bank behavior through their assessments.

45. (C) Alpha Bank's failure to meet the qualifying disclosure criteria required to apply that specific methodology.
Regulators can impose a direct sanction if a bank fails to meet specific disclosure requirements that are set as qualifying criteria for advanced methodologies under Pillar 1. In this scenario, Alpha Bank was likely denied the use of a lower risk-weighting methodology because it did not provide the mandatory public information required to validate the use of that approach.

46. (B) P-3, Q-4, R-1, S-2
Proprietary information is defined as data that would make a bank's investment less valuable if shared. Confidential information refers to details provided under legal or counterparty agreements. Material information is that which could influence economic decisions if omitted. Finally, supplementary materials like Management's Discussion and Analysis (MD&A) are expected to undergo sufficient internal scrutiny to ensure their accuracy.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Pillar 3 disclosures are not automatically required to be audited by an external party. This is because much of the core information is already part of the audited annual financial statements. For additional supplementary material, the regulatory framework relies on management to apply sufficient internal scrutiny, ensuring the data is accurate and consistent with the bank's audited figures.

48. (B) Pillar 3 disclosures : Must always be audited by an external auditor
Non-compliance penalties must be disclosed in the balance sheet, and the materiality concept is consistent with accounting standards. Furthermore, Table DF-3 requires at least quarterly disclosure. However, it is incorrect to say that all Pillar 3 disclosures must always be audited by an external auditor. The requirement for external audits usually only applies to the main financial statements.

49. (C) Statements (I), (II), (III), and (IV)
Pillar 3 disclosures generally occur half-yearly, but critical tables like DF-2, DF-3, and DF-4

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67. (D) Market discipline exerting pressure on a financial institution

The scenario where uninsured institutional investors sell off debt, causing market yields to spike in response to increased risk, is a classic example of market discipline. These market signals put direct financial pressure on the bank by increasing its cost of funding. This mechanism encourages the bank to manage its risks more prudently to regain investor confidence and lower yields.

68. (A) It is classified as confidential information provided under legal terms.

Banks are restricted from disclosing specific customer data because it is classified as confidential information provided under legal agreements or counterparty relationships. Publicly revealing such details would violate legal obligations and compromise client privacy. Regulatory disclosure frameworks allow for the protection of this data, ensuring that transparency requirements do not force a breach of contract or legal confidentiality.

69. (C) Quarterly

To remain compliant with regulatory guidelines, Gamma Bank must ensure that Table DF-4 is disclosed on a quarterly basis. This table provides information on credit risk for portfolios subject to the standardized approach. Like other key credit and capital tables, the quarterly frequency is necessary to provide stakeholders with regular and timely insights into the bank's risk exposures.

70. (B) Use the higher market prices as a valuable signal of greater risk-taking to discipline the bank.

Under the principles of market discipline, regulators should use market data, such as a sudden spike in debt yields, as a valuable signal of increased risk-taking. These signals provide a real-time assessment from market participants that can complement formal supervisory reviews. By paying attention to these market indicators, regulators can intervene or increase scrutiny to ensure the bank's stability.

increasing dividend payments and staff bonus payments during stable times
(C) The share of earnings retained by banks should increase the nearer their actual capital levels are to the minimum requirement
(D) Banks should choose in normal times to operate in the buffer range simply to compete with the market share of other banks

Oct/Nov 2013

15. The NSFR framework requires stable funding for some proportion of lending to the real economy. This calibration criterion is most appropriately classified under:
(A) Asset quality and liquidity value
(B) Bank behaviour
(C) Funding tenor
(D) Resilient credit creation

May/June 2025

16. How is procyclicality defined in the context of financial and economic cycles?
(A) The tendency of financial variables to fluctuate around a trend during the economic cycle
(B) The tendency of financial variables to remain static regardless of the economic cycle
(C) The tendency of financial variables to fluctuate inversely to the trend during the economic cycle
(D) The tendency of banks to build up capital buffers during normal times

Oct/Nov 2022

17. Which of the following is NOT one of the Liquidity Risk Monitoring Tools prescribed under the liquidity framework?
(A) Net Stable Funding Ratio (NSFR)
(B) Contractual Maturity Mismatch
(C) Concentration of funding
(D) Available Unencumbered Assets

May/June 2014

18. The Liquidity Coverage Ratio (LCR) ensures that a bank has sufficient non-captive high-quality liquid assets (HQLA) to meet its liquidity needs over a stress scenario lasting how many days?
(A) 15 calendar days
(B) 30 calendar days
(C) 60 calendar days
(D) 90 calendar days

Oct/Nov 2010

19. Which statement is incorrect regarding the calibrations and assumptions of the Net Stable Funding Ratio (NSFR)?
(A) Short-term deposits provided by retail customers are considered behaviourally more stable than wholesale funding of the same maturity
(B) Unencumbered, high-quality assets that can be securitised do not need to be wholly financed with stable funding
(C) The NSFR assumes banks may seek to roll over a significant proportion of maturing loans to preserve customer relationships
(D) The NSFR is calibrated such that shorter-term liabilities are assumed to be more stable than longer-term liabilities

May/June 2019

20. Which statement correctly applies to the Exposure Measure for calculating the leverage ratio?
(A) On-balance sheet, non-derivative exposures are included net of specific provisions or accounting valuation adjustments
(B) Netting of loans and deposits is strictly permitted under certain conditions to reduce the total exposure measure
(C) Banks must take account of physical or financial collateral to reduce the exposure measure across all business lines
(D) Off-balance sheet items are excluded entirely from the total exposure measure to simplify the regulatory reporting process

Oct/Nov 2008

21. The following steps describe the procyclical feedback loop during boom times. Arrange them in the correct sequential order:
I. Higher amount of profits is distributed as dividends instead of building capital.
II. Debtors tend to do well, servicing loans on time and improving credit ratings.
III. There is more demand for credit, leading banks to become aggressive and relax credit standards.
IV. Banks' loan losses and capital requirements fall below their long-run average, requiring

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of elements subject to the restriction on distributions
(B) Distributable profits before the deduction of elements subject to the restriction on distributions
(C) Net interest income after taxes and loan loss provisions
(D) Gross operating profits excluding discretionary bonus payments

May/June 2010

8. Which statement correctly identifies an operational requirement for the stock of liquid assets under the LCR framework?
(A) The assets should be co-mingled and used as hedges on trading positions
(B) The assets must be available at all times to be converted into cash and should be unencumbered
(C) The assets should be managed by multiple decentralized functions without explicit control by the ALCO
(D) The assets must be designated as collateral or credit enhancement in structured transactions

Oct/Nov 2015

9. Which of the following is NOT used as a supplementary indicator for the CCCB decision?
(A) Incremental C-D ratio for a moving period of three years
(B) Minimum regulatory Cash Reserve Ratio (CRR) level
(C) Industry Outlook (IO) assessment index
(D) Interest coverage ratio

May/June 2013

10. By enabling banks to maintain the provision of key financial services to the real economy without breaching minimum capital requirements, capital buffers mitigate negative externalities related to which of the following?
(A) Excessive liquidity accumulation
(B) Insufficient deposit mobilization
(C) Excessive deleveraging or fire sales
(D) Increased operational inefficiencies

Oct/Nov 2019

11. The following steps outline the process of identifying Domestic Systemically Important Banks (D-SIBs). Arrange them in the correct chronological order:
I. Segregate D-SIBs into different buckets based on their scores.
II. Compute a composite score of systemic importance based on size, interconnectedness, substitutability, and complexity.
III. Apply a loss absorbency capital surcharge in a graded manner.
IV. Select a sample of banks having a size beyond 2% of GDP.
Which of the following represents the correct sequential order?
(A) IV, I, II, III
(B) II, IV, I, III
(C) II, I, IV, III
(D) IV, II, I, III

May/June 2015

12. The capital conservation buffer is required to be maintained at 2.5% of Risk Weighted Assets (RWAs). It is comprised exclusively of which of the following?
(A) Additional Tier 1 capital
(B) Tier 2 capital
(C) Common Equity Tier 1 capital
(D) Total Eligible Capital

Oct/Nov 2007

13. Which statement is incorrect regarding the characteristics of High Quality Liquid Assets (HQLA)?
(A) The formula for determining the price of a high-quality liquid asset must depend on restrictive assumptions
(B) High creditworthiness of the issuer and a low degree of subordination increase an asset's liquidity
(C) The stock of HQLA should not be subject to the risk of high adverse correlation with risky assets
(D) Assets must be listed on a well-established exchange to increase transparency

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May/June 2011

14. Which statement correctly describes the rebuilding of the capital conservation buffer?
(A) Banks must use future predictions of economic recovery as justification for maintaining generous distributions
(B) Banks should look to rebuild buffers by

58. (A) Only Statement (I) is correct.
If disclosure is a qualifying criterion for using a specific Pillar 1 methodology, such as lower risk weightings, the regulator can prevent the bank from applying that methodology. This is a direct sanction. However, Statement II is incorrect because direct additional capital requirements are generally not the intended or standard response for most common non-disclosure incidents under Pillar 3.

59. (A) Statements (I), (III), (IV), and (V)
Effective market discipline requires participants to have access to timely information and reliable financial data to monitor investments. Credit ratings and independent outside audits further enhance transparency. Statement II is incorrect because stringent disclosure rules are designed to increase, not decrease, market transparency. Together, these elements enable market participants to exert discipline and encourage prudent bank behavior.

60. (B) Statements (II) and (III)
Statement I is incorrect because the Pillar 3 framework was specifically designed not to conflict significantly with accounting standards. Statement II is correct as regulators may update disclosure requirements as the industry evolves. Statement III is also correct, noting that accounting standards have a broader scope compared to the more specific focus of Pillar 3 on capital adequacy.

61. (C) The Materiality Concept and User Test
Delta Bank's decision to omit a minor operational loss because it would not influence a user's economic decisions is a direct application of the materiality concept and the user test. These principles allow banks to focus on providing relevant information while omitting details that are not significant enough to change the assessment of the institution's financial health.

62. (A) Capital Adequacy
Table DF-2 contains data on Capital Adequacy. Because capital levels and the components of the capital base can change frequently, the regulatory framework mandates that this information be disclosed on a quarterly basis. This ensures that market participants have up-to-date information to assess the bank's solvency and risk-bearing capacity, more frequently than the standard half-yearly cycle.

63. (C) Provide a direct link in the financial results to the disclosures available on the bank's website.
When it is operationally inconvenient to include full disclosure tables in printed results, the bank must provide a direct link in those results to the information on its website. This ensures that the data remains publicly available and easy to find for all interested stakeholders. This practice maintains compliance with transparency requirements while allowing for efficient digital distribution.

64. (C) Its intricate ownership hierarchies and multiple complex business lines.
The opacity of Epsilon Bank's balance sheet, which made it difficult for participants to detect high-risk derivatives, was most likely caused by its intricate ownership hierarchies and multiple complex business lines. These structural features create layers of complexity that can hide risks from stakeholders, highlighting the critical importance of clear and detailed Pillar 3 disclosures to ensure transparency.

65. (B) Protection of Proprietary Information
Delta Bank can restrict the release of specific parameter estimates for its proprietary credit risk algorithm under the principle of protecting proprietary information. Disclosing such details could harm its competitive advantage. In these cases, the bank must still provide more general information about the algorithm and explain why the specific proprietary details have been excluded from the disclosure.

66. (D) Table DF-3: Credit Risk: General Disclosures for All Banks.
While many disclosures are half-yearly, certain tables must be published quarterly to ensure timely monitoring of risks. Table DF-3, which provides general disclosures for credit risk, is one of those required on a quarterly basis. This allows market participants to see more frequent updates on the bank's credit exposures and asset quality, which can change rapidly in volatile markets.

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less loan loss provisions.
Which of the following represents the correct sequential order?
(A) III, IV, II, I
(B) II, III, I, IV
(C) III, II, IV, I
(D) I, III, II, IV

May/June 2005

22. What is the maximum percentage of total risk-weighted assets (RWA) that the Counter-Cyclical Capital Buffer (CCCB) can reach when fully activated?
(A) 1.5%
(B) 2.0%
(C) 2.5%
(D) 3.0%

Oct/Nov 2014

23. What is the fundamental conceptual difference between capital adequacy ratios and the leverage ratio?
(A) Capital adequacy ratios place a cap on borrowings based on equity, while the leverage ratio is risk-based and asset-focused
(B) Capital adequacy ratios only consider off-balance sheet items, while the leverage ratio only considers on-balance sheet items
(C) Capital adequacy ratios are intended for short-term liquidity shocks, while the leverage ratio addresses long-term structural funding
(D) Capital adequacy ratios are based on the risk of business activities, while the leverage ratio measures the extent to which a bank finances its assets with equity irrespective of risk

May/June 2016

24. Which of the following is NOT a sub-indicator used to assess Substitutability for identifying Domestic Systemically Important Banks?
(A) Assets under custody
(B) Payments made in ₹ using RTGS/NEFT Systems
(C) Underwritten transactions in debt and equity markets
(D) Cross Jurisdictional Liabilities

Oct/Nov 2020

25. Which statement is incorrect regarding the Counter-Cyclical Capital Buffer (CCCB) framework?
(A) The CCCB may be maintained in the form of Common Equity Tier 1 capital only
(B) The credit-to-GDP gap is the only indicator used by the Reserve Bank of India for CCCB decisions
(C) The CCCB decision would normally be pre-announced with a lead time of 4 quarters
(D) CCCB shall be maintained on a solo basis as well as on consolidated basis

May/June 2021

26. How is the Net Stable Funding Ratio (NSFR) defined?
(A) The amount of required stable funding relative to the amount of available stable funding
(B) The stock of High Quality Liquid Assets relative to total net cash outflows over 30 days
(C) The total expected cash inflows relative to the total expected cash outflows
(D) The amount of available stable funding relative to the amount of required stable funding

Oct/Nov 2011

27. Systemically Important Banks (SIBs) are perceived as 'Too Big to Fail' (TBTF). Which of the following represents the most appropriate consequence of this perception?
(A) The perceived expectation of government support amplifies risk-taking, reduces market discipline, and creates competitive distortions
(B) It encourages SIBs to rely exclusively on equity funding to improve operational efficiency and long-term sustainability
(C) It eliminates the need for any additional policy measures or capital surcharges for these banks during economic growth
(D) It automatically insulates these banks from cross-segmental linkages and external shocks through diversified business models

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CHAPTER 31

Basel III Buffers, Liquidity Ratios, Leverage Ratio

Oct/Nov 2012

1. What is the minimum Leverage Ratio required to be maintained by banks other than Domestic Systemically Important Banks (D-SIBs)?
(A) 3.0%
(B) 3.5%
(C) 4.0%
(D) 4.5%

May/June 2023

2. Which statement is incorrect regarding Level 2A assets under the LCR framework?
(A) A minimum 15% haircut should be applied to the current market value of each Level 2A asset
(B) Corporate bonds not issued by a bank or financial institution and rated AA- or above are eligible
(C) Level 2A assets are permitted to comprise up to 50% of the total stock of HQLA
(D) Commercial Papers not issued by a bank and having a short-term rating equivalent to long-term AA- or above are eligible

Oct/Nov 2021

3. What is the definition of the Basel III leverage ratio?
(A) $\text{LeverageRatio} = \frac{\text{Total Risk Weighted Assets}}{\text{ExposureMeasure}} \geq 4.0\%$
(B) $\text{LeverageRatio} = \frac{\text{Total Capital (Tier1} + \text{Tier2)}}{\text{RiskWeightedAssets}} \geq 9.0$
(C) $\text{LeverageRatio} = \frac{\text{Capital Measure (Tier1Capital)}}{\text{ExposureMeasure}} \geq 3.5$
(D) $\text{LeverageRatio} = \frac{\text{ExposureMeasure}}{\text{CapitalMeasure (Tier1Capital)}} \geq 3.5$

May/June 2007

4. The aim of the Counter-Cyclical Capital Buffer (CCCB) regime is twofold. Which of the following most appropriately describes its broader macro-prudential goal?
(A) Forcing banks to liquidate all non-performing assets during an economic downturn to maintain balance sheet quality
(B) Replacing the risk-based capital adequacy regime with a non-risk based leverage cap to simplify regulatory oversight
(C) Restricting the banking sector from indiscriminate lending in periods of excess credit growth associated with system-wide risk
(D) Ensuring banks maintain sufficient high-quality liquid resources to overcome a 30-day stress situation without aid

Oct/Nov 2005

5. What does maturity transformation mean in the context of banking business?
(A) Converting long-term deposits into short-term liquid investments to manage daily cash flow requirements
(B) Transforming short maturities (deposits) into longer maturities (investments) to create funding liquidity
(C) Funding liquid long-term liabilities with illiquid short-term assets through various market instruments
(D) Matching the exact maturities of assets and liabilities to eliminate liquidity risk and interest rate volatility

May/June 2018

6. Which Liquidity Risk Monitoring Tool is most appropriate to identify sources of funding of such significance that their withdrawal could trigger liquidity problems?
(A) Contractual Maturity Mismatch
(B) Concentration of funding
(C) Available Unencumbered Assets
(D) LCR by Significant Currency

Oct/Nov 2024

7. What is the precise definition of "earnings" in the context of the Capital Conservation Buffer framework?
(A) Distributable profits after the deduction

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liquidity position due to disruptions in regular sources of funding.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2023

35. Consider the following statements regarding the treatment of encumbered assets under the NSFR:

I Assets encumbered for a period of between six months and less than one year that would, if unencumbered, receive an RSF factor lower than or equal to 50%, receive a 50% RSF factor.
II Assets encumbered for one year or more receive a 100% RSF factor.

Which of the above statement(s) is/are correct?

(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2009

36. The Central Statistical Office reports the latest GDP figure at market prices as ₹ 200 Lakh Crore. The RBI is preparing the sample for identifying Domestic Systemically Important Banks (D-SIBs). What is the minimum balance sheet size a bank must possess to be automatically selected in this sample?

(A) ₹ 1 Lakh Crore
(B) ₹ 2 Lakh Crore
(C) ₹ 4 Lakh Crore
(D) ₹ 10 Lakh Crore

Oct/Nov 2017

37. Match the items in List I with the items in List II and select the correct option.

List I: (D-SIB Indicators)
P. Interconnectedness
Q. Substitutability
R. Complexity
S. Size

List II: (Sub-indicators)
1. Assets under custody
2. Intra-financial system assets
3. Notional amount of OTC Derivatives
4. Total exposure as defined for use in Basel III Leverage Ratio

(A) P-2, Q-1, R-3, S-4
(B) P-1, Q-3, R-2, S-4
(C) P-3, Q-2, R-1, S-4
(D) P-4, Q-1, R-2, S-3

May/June 2024

38. Consider the following components of the stress scenario specified for the Liquidity Coverage Ratio (LCR), involving a combined idiosyncratic and market-wide shock:

I A partial loss of unsecured wholesale funding capacity.
II A public credit rating downgrade by up to three notches.
III Unscheduled draws on committed but unused credit and liquidity facilities.
IV Run-off of a proportion of retail deposits.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (IV)
(B) (II), (III), and (IV)
(C) (I), (III), and (IV)
(D) (I), (II), (III), and (IV)

Oct/Nov 2018

39. Read the given assertion and reason and select the most appropriate option.

Assertion (A): Counter-cyclical capital requirements should be designed to become binding during periods of excessive credit growth to address procyclicality.

Reason (R): Capital requirements act as compulsory buffers imposed on banks and have an incentive function to drive and limit risk-taking by bank managers.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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May/June 2012

40. Identify the incorrect pair regarding the Required Stable Funding (RSF) factors assigned to specific assets.
(A) All assets that are encumbered for a period of one year or more — 100%
(B) Unencumbered 'standard' residential mortgages with a residual maturity of one year or more — 65%
(C) Cash posted as initial margin for derivative contracts — 85%
(D) Unencumbered SLR Securities — 10%

Oct/Nov 2006

41. Delta Bank reports the following metrics: On-balance sheet items (excluding derivatives and SFTs) equal ₹ 15,000 million. Asset amounts deducted in determining Tier 1 capital equal ₹ 1,000 million. Total derivative exposures equal ₹ 2,000 million. Total SFT exposures equal ₹ 3,000 million. Off-balance sheet gross notional amount is ₹ 4,000 million, subject to adjustments of negative ₹ 2,500 million for conversion to credit equivalent amounts. What is the Total Exposure Measure for calculating the Leverage Ratio?
(A) ₹ 19,000 million
(B) ₹ 20,500 million
(C) ₹ 23,000 million
(D) ₹ 24,500 million

May/June 2006

42. Match the items in List I with the items in List II and select the correct option.
List I: (Assets)
P. Coins and banknotes
Q. Unencumbered Level 1 assets (excluding coins, banknotes and CRR)
R. Unencumbered Level 2A assets
S. Unencumbered Level 2B assets
List II: (RSF Factors)
1. 0%
2. 5%
3. 15%
4. 50%
(A) P-2, Q-3, R-4, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-1, Q-2, R-3, S-4
(D) P-4, Q-1, R-2, S-3

Oct/Nov 2014

43. Consider the following criteria and assumptions used in the calibration of Available Stable Funding (ASF) and Required Stable Funding (RSF):
I The NSFR assumes that longer-term liabilities are more stable than shorter-term liabilities.
II Short-term deposits provided by retail customers are behaviourally more stable than wholesale funding of the same maturity.
III High-quality assets that can be readily securitised must be wholly financed with stable funding.
IV Short-dated assets maturing in less than one year require a smaller proportion of stable funding because banks can allow them to mature.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), and (III)

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May/June 2023

44. Consider the following statements regarding the thresholds for the Counter-Cyclical Capital Buffer (CCCB):
I The lower threshold (L) of the credit-to-GDP gap where the CCCB is activated shall be set at 3 percentage points.
II The upper threshold (H) where the CCCB reaches its maximum shall be kept at 15 percentage points.
III If the credit-to-GDP gap is below 3 percentage points, the minimum CCCB requirement defaults to 0.5%.
Which of the above statement(s) is/are correct?
(A) (I) and (II)
(B) (II) and (III)
(C) (I) and (III)
(D) (I), (II), and (III)

Oct/Nov 2012

45. The credit-to-GDP gap for a developing economy has surged and currently stands at 16 percentage points. Under the CCCB framework implemented by RBI, what will be

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the maximum Counter-Cyclical Capital Buffer (CCCB) required to be maintained by banks?
(A) 1.5% of RWA
(B) 2.5% of RWA
(C) 3.0% of RWA
(D) 15.0% of RWA

May/June 2019

46. Match the items in List I with the items in List II and select the correct option.
List I: (Off-balance Sheet Items)
P. Direct credit substitutes (e.g., general guarantees of indebtedness)
Q. Commitments with an original maturity of up to one year
R. Commitments unconditionally cancellable at any time without prior notice
S. Certain transaction-related contingent items (e.g., performance bonds)
List II: (Credit Conversion Factors)
1. 10%
2. 20%
3. 50%
4. 100%
(A) P-1, Q-3, R-2, S-4
(B) P-4, Q-2, R-1, S-3
(C) P-2, Q-4, R-3, S-1
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2021

47. Read the given assertion and reason and select the most appropriate option.
Assertion (A): Without financial tensions, the Liquidity Coverage Ratio (LCR) cannot fall below 100% on an ongoing basis.
Reason (R): During periods of financial stress, maintaining the LCR at 100% is strictly enforced by supervisors, and banks are forbidden from utilizing their stock of HQLA.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2010

48. Assuming a requirement of 2.5% each for capital conservation buffer and CCCB, identify the incorrect pair matching the Common Equity Tier 1 Ratio bands to the Minimum Capital Conservation Ratios (expressed as % of earnings).
(A) >5.5% to 6.75% — 100%
(B) >6.75% to 8.0% — 80%
(C) >8.0% to 9.25% — 60%
(D) >9.25% to 10.50% — 20%

Oct/Nov 2015

49. Under the NSFR framework, consider the following liabilities and capital items and their assignment to a 100% Available Stable Funding (ASF) factor:
I Total regulatory capital excluding the proportion of Tier 2 instruments with residual maturity of less than one year.
II Capital instruments with effective residual maturity of one year or more.
III Stable non-maturity deposits provided by retail customers.
IV Other liabilities with effective residual maturity of one year or more.
V Operational deposits generated by clearing, custody, or cash management activities.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV)
(B) (I), (III), and (V)
(C) (II), (IV), and (V)
(D) (I), (II), (III), and (IV)

May/June 2007

50. Consider the following statements regarding the calculation of cash flows under the LCR:
I Total expected cash outflows are calculated by multiplying outstanding balances of liabilities by expected run-off rates.
II Total expected cash inflows are capped at an aggregate of 75% of total expected cash outflows.
III Banks are explicitly permitted to double count items if an asset is included in the stock of HQLA and generates an associated cash inflow.
Which of the above statement(s) is/are correct?
(A) (I) and (II)
(B) (I) and (III)

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mismatch, concentration of funding, and available unencumbered assets. While the net stable funding ratio is a regulatory standard, it is not categorized as one of the specific monitoring tools like the daily liquidity returns. These tools provide supervisors with detailed data on a bank's daily liquidity profile and vulnerabilities.

18. (B) 30 calendar days
The liquidity coverage ratio is designed to ensure that a bank maintains an adequate level of unencumbered high-quality liquid assets to survive a significant liquidity stress scenario. The framework specifically models this stress period to last for thirty calendar days. This duration provides enough time for the bank and supervisors to take corrective actions and for the market to stabilize.

19. (D) The NSFR is calibrated such that shorter-term liabilities are assumed to be more stable than longer-term liabilities
The net stable funding ratio is calibrated on the assumption that longer-term liabilities are more stable than shorter-term liabilities. Shorter-term funding is generally considered more volatile and prone to withdrawal during periods of market stress. Therefore, the framework requires a higher proportion of stable funding for assets that cannot be easily liquidated or reduced within a one-year timeframe.

20. (A) On-balance sheet, non-derivative exposures are included net of specific provisions or accounting valuation adjustments
For the calculation of the leverage ratio, on-balance sheet non-derivative exposures are included net of specific provisions and accounting valuation adjustments. This ensures the exposure measure reflects the actual economic value of the assets. However, the framework generally does not allow for the netting of loans and deposits or the use of physical collateral to reduce the total exposure measure.

21. (C) III, II, IV, I
The procyclical feedback loop during boom times begins with increased demand for credit, leading banks to relax credit standards. As a result, debtors perform well and service loans on time. This leads to lower loan losses and capital requirements for banks. Consequently, a higher proportion of profits is often distributed as dividends rather than being used to build capital.

22. (C) 2.5%
The counter-cyclical capital buffer is designed to vary between 0% and 2.5% of total risk-weighted assets. The specific level is determined by the regulator based on the credit-to-GDP gap and other supplementary indicators. When fully activated at 2.5%, it provides a significant additional layer of loss-absorbing capital to protect the banking system from systemic risks during downturns.

23. (D) Capital adequacy ratios are based on the risk of business activities, while the leverage ratio measures the extent to which a bank finances its assets with equity irrespective of risk
Capital adequacy ratios are risk-based, meaning they measure capital against assets weighted by their perceived risk. In contrast, the leverage ratio is a non-risk-based measure that evaluates capital against total exposure. It serves as a backstop to the risk-based framework, preventing banks from becoming overly leveraged even if their assets are assigned low risk weights under regulatory internal models.

24. (D) Cross Jurisdictional Liabilities
To assess the substitutability of a bank for identifying domestic systemically important banks, indicators such as assets under custody, payments made through RTGS/NEFT, and underwritten transactions are used. Cross-jurisdictional liabilities are typically used to identify global systemically important banks rather than domestic ones. Substitutability measures the difficulty other banks would have in replacing the services provided by a bank.

25. (B) The credit-to-GDP gap is the only indicator used by the Reserve Bank of India for CCCB decisions
Although the credit-to-GDP gap is the primary indicator used for decisions regarding the counter-cyclical capital buffer, it is not the only one. The Reserve Bank of India also considers supplementary indicators such as the

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R. Less stable non-maturity deposits provided by retail customers
S. Funding with residual maturity of less than one year provided by non-financial corporate customers

List II: (ASF Factors)
1. 100%
2. 95%
3. 90%
4. 50%

(A) P-1, Q-2, R-3, S-4
(B) P-2, Q-3, R-4, S-1
(C) P-4, Q-1, R-2, S-3
(D) P-3, Q-4, R-1, S-2

Oct/Nov 2007

57. Zenith Bank maintains a Common Equity Tier 1 (CET1) risk-based capital ratio of 7.0%, a Tier 1 capital ratio of 8.0%, and a Total capital ratio of 10.0%. The minimum regulatory capital requirements are 5.5% for CET1, 7.0% for Tier 1, and 9.0% for Total Capital. Under the Capital Conservation Buffer framework, what is the maximum payout ratio allowed to the bank as a percentage of eligible retained income?
(A) 0%
(B) 20%
(C) 40%
(D) 60%

May/June 2011

58. Consider the following statements regarding the Capital Conservation Buffer framework:
I The buffer is comprised of Common Equity Tier 1 capital above the regulatory minimum total capital requirement of 9%.
II When capital levels fall into the conservation range, capital distribution constraints are imposed, but banks are able to conduct business operations as normal.

Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2013

59. Under the NSFR framework, consider the following assets and their assignment to a 50% Required Stable Funding (RSF) factor:
I Unencumbered Level 2B assets.
II HQLA encumbered for a period of six months or more and less than one year.
III Deposits held at other financial institutions for operational purposes.
IV All claims on RBI with residual maturities of less than six months.
V Unencumbered Level 2A assets.

Which of the above statement(s) is/are correct?
(A) (I), (II), and (V)
(B) (I), (II), and (III)
(C) (II), (III), and (IV)
(D) (III), (IV), and (V)

May/June 2025

60. Consider the following statements regarding the Capital Measure of the leverage ratio:
I The capital measure is the Tier 1 capital of the risk-based capital framework.
II The capital measure takes into account various regulatory adjustments and deductions.
III The capital measure includes Tier 2 capital if it is primarily composed of retained earnings.

Which of the above statement(s) is/are correct?
(A) (I) and (III)
(B) (I) and (II)
(C) (II) and (III)
(D) (I), (II), and (III)

Oct/Nov 2022

61. A bank registers NSFR derivative liabilities of ₹ 800 million and NSFR derivative assets of ₹ 600 million. What is the amount of Required Stable Funding (RSF) applied specifically as a standalone factor to the derivative liabilities (before any net calculation is considered)?
(A) ₹ 0 million
(B) ₹ 20 million
(C) ₹ 30 million
(D) ₹ 40 million

May/June 2014

62. A corporate client operates with an average annual turnover of ₹ 4.5 crore. The total

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aggregated funding provided by this client to the bank in the form of deposits is ₹ 6 crore. Under the LCR disclosure standard in India, can this client's deposits be classified and treated as retail deposits under "Small Business Customers"?
(A) No, because the total aggregated funding exceeds the limit of less than ₹ 5 crore
(B) Yes, because the total average annual turnover is less than ₹ 5 crore
(C) Yes, because turnover and funding limits are evaluated independently for classification
(D) No, because small business customers must have a turnover strictly below ₹ 1 crore

Oct/Nov 2010

63. Sigma Bank holds unadjusted Level 1 assets worth ₹ 1,000 million and unadjusted Level 2A assets worth ₹ 400 million on the first day of a stress period. The bank has not undertaken any repo or reverse repo transactions. Under LCR guidelines, what is the maximum value of Level 2 assets that can be included in the stock of HQLA after applying the requisite haircuts?
(A) ₹ 340 million
(B) ₹ 400 million
(C) ₹ 666.67 million
(D) ₹ 1,000 million

May/June 2016

64. Beta Bank is designated as a D-SIB and placed in Bucket 4 based on its systemic importance score. If the bank's Total Risk Weighted Assets (RWA) amount to ₹ 5,00,000 crore, what is the exact amount of additional capital charge in the form of CET1 capital it is required to maintain?
(A) ₹ 1,000 crore
(B) ₹ 3,000 crore
(C) ₹ 4,000 crore
(D) ₹ 5,000 crore

Oct/Nov 2008

65. Epsilon Bank possesses the following assets: Coins and banknotes of ₹ 100 crore; Unencumbered Level 1 assets (excluding coins/banknotes/CRR) of ₹ 400 crore; and Unencumbered standard residential mortgages with a residual maturity of 2 years of ₹ 1,000 crore. What is the Required Stable Funding (RSF) calculated for these assets?
(A) ₹ 650 crore
(B) ₹ 670 crore
(C) ₹ 700 crore
(D) ₹ 720 crore

May/June 2005

66. Over the subsequent 30 calendar days, Gamma Bank projects total expected cash outflows of ₹ 5,000 crore and total expected cash inflows of ₹ 4,000 crore based on contractual receivables. Calculating the Total Net Cash Outflows according to the LCR parameters yields which of the following amounts?
(A) ₹ 1,000 crore
(B) ₹ 1,250 crore
(C) ₹ 2,000 crore
(D) ₹ 3,750 crore

Oct/Nov 2020

67. A bank provides an unconditionally revocable credit facility of ₹ 2,000 million to a corporate entity. Based on the NSFR framework for off-balance sheet items, what is the Required Stable Funding (RSF) amount allocated for the currently undrawn portion of this specific facility?
(A) ₹ 60 million
(B) ₹ 100 million
(C) ₹ 200 million
(D) ₹ 1,000 million

May/June 2021

68. A bank reports adjusted Level 1 assets of ₹ 850 million and adjusted Level 2A assets of ₹ 150 million. The bank intends to include Level 2B assets in its HQLA. Under the LCR formulation, what is the maximum permitted amount of Level 2B assets in the stock of HQLA (ignoring the 1/4th Level 1 cap for this specific calculation if the primary limit is binding)?

$$\text{MaxLevel2B} = \frac{15}{85} \times (\text{AdjustedLevel1} + \text{AdjustedLevel2A})$$

(A) ₹ 150.00 million
(B) ₹ 176.47 million
(C) ₹ 212.50 million
(D) ₹ 250.00 million

Oct/Nov 2011

69. Omega Bank's liability profile consists of: Total regulatory capital of ₹ 500 crore; stable

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non-maturity retail deposits of ₹ 1,000 crore; and funding with residual maturity of less than one year provided by non-financial corporate customers of ₹ 400 crore. Using the NSFR framework, what is the computed Available Stable Funding (ASF) for these items?
(A) ₹ 1,650 crore
(B) ₹ 1,750 crore
(C) ₹ 1,850 crore
(D) ₹ 1,900 crore

May/June 2008

70. Alpha Bank holds a portfolio of standard loans to retail customers with a residual maturity of 9 months. These assets have been encumbered for a period of 8 months. What is the specific Required Stable Funding (RSF) factor applied to these encumbered assets?
(A) 0%
(B) 50%
(C) 85%
(D) 100%

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(C) (II) and (III)
(D) (I), (II), and (III)

Oct/Nov 2005

51. Delta Bank reports the following metrics: On-balance sheet items (excluding derivatives and SFTs) equal ₹ 15,000 million. Asset amounts deducted in determining Tier 1 capital equal ₹ 1,000 million. Total derivative exposures equal ₹ 2,000 million. Total SFT exposures equal ₹ 3,000 million. Off-balance sheet gross notional amount is ₹ 4,000 million, subject to adjustments of negative ₹ 2,500 million for conversion to credit equivalent amounts. What is the Total Exposure Measure for calculating the Leverage Ratio?
(A) ₹ 19,000 million
(B) ₹ 20,500 million
(C) ₹ 23,000 million
(D) ₹ 24,500 million

May/June 2018

52. Identify the correct pair matching the D-SIB bucket with its Additional Common Equity Tier 1 requirement as a percentage of Risk Weighted Assets.
(A) Bucket 1 — 0.40%
(B) Bucket 2 — 0.80%
(C) Bucket 5 — 0.20%
(D) Bucket 3 — 0.60%

Oct/Nov 2024

53. Consider the following statements regarding the calculation of Adjusted Level 1 and Level 2 assets under the LCR:
I Adjusted Level 1 assets are arrived at by adding back the amount of securities lent (repo) and by subtracting the amount of securities received (reverse repo) with residual maturity up to 30 days.
II Corporate Bonds are the only Level 2 assets where repo transactions are permitted by regulators.
Which of the above statement(s) is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2013

54. Read the given assertion and reason and select the most appropriate option.
Assertion (A): Under Basel III, the leverage ratio is calibrated to act as a credible supplementary backstop measure to the risk-based capital requirements.
Reason (R): Prior to the crisis, a number of banks reported healthy risk-based capital ratios but nevertheless found themselves in need of capital support due to being overly leveraged.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2019

55. Consider the following assets and their eligibility to be included as Level 1 assets in the stock of liquid assets without any limit or haircut:
I Cash including cash reserves in excess of required CRR.
II Government security in excess of the minimum SLR requirement.
III Marketable securities issued by foreign sovereigns assigned a 0% risk weight.
IV Corporate bonds rated AA- or above by an Eligible Credit Rating Agency.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV)
(B) (I), (II), and (III)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

May/June 2015

56. Match the items in List I with the items in List II and select the correct option.
List I: (Liabilities)
P. Total regulatory capital (excluding Tier 2 instruments with residual maturity < 1 year)
Q. Stable non-maturity deposits provided by retail customers

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are not pledged as collateral and are under the control of the function responsible for managing liquidity. This operational readiness is critical for surviving a thirty-day stress scenario.

9. (B) Minimum regulatory Cash Reserve Ratio (CRR) level
While the credit-to-GDP gap is the primary indicator for activating the counter-cyclical capital buffer, several supplementary indicators are also used. These include the incremental credit-to-deposit ratio, the industry outlook assessment index, and the interest coverage ratio. The minimum regulatory cash reserve ratio is a separate monetary policy tool and is not used as a trigger for this buffer.

10. (C) Excessive deleveraging or fire sales
Capital buffers are designed to be used during periods of stress, allowing banks to absorb losses while continuing to provide essential financial services. By preventing banks from breaching minimum capital requirements, these buffers reduce the need for excessive deleveraging or fire sales of assets. This stability protects the real economy from the negative externalities of a sudden credit crunch.

11. (D) IV, II, I, III
The process for identifying domestic systemically important banks begins by selecting a sample of banks with a size exceeding 2% of GDP. Next, a composite systemic importance score is computed using various indicators. Banks are then segregated into buckets based on these scores. Finally, a graded loss absorbency capital surcharge is applied to the identified banks to increase resilience.

12. (C) Common Equity Tier 1 capital
The capital conservation buffer, which is set at 2.5% of risk-weighted assets, must be comprised exclusively of common equity tier 1 capital. This represents the highest quality of capital capable of absorbing losses on a going-concern basis. By requiring this specific capital type, the framework ensures banks have the most resilient resources available during periods of significant economic stress.

13. (A) The formula for determining the price of a high-quality liquid asset must depend on restrictive assumptions
The formula for determining the price of a high-quality liquid asset should not depend on restrictive assumptions. Transparency in valuation is a key characteristic of liquidity. Assets that are easily valued and have low volatility in price tend to be more reliable during market stress. This ensures that the stock of liquid assets can be accurately measured daily.

14. (C) The share of earnings retained by banks should increase the nearer their actual capital levels are to the minimum requirement
When a bank's capital levels fall into the conservation buffer range, it must increase the share of earnings it retains. This mechanism ensures that capital is rebuilt during periods of stress or following losses. The closer a bank's capital level is to the minimum requirement, the higher the percentage of profits it must retain instead of distributing to shareholders.

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15. (D) Resilient credit creation
The net stable funding ratio framework is calibrated to ensure that a proportion of lending to the real economy is supported by stable funding. This specific calibration criterion, known as resilient credit creation, aims to prevent banks from relying excessively on volatile short-term funding to support long-term lending. This promotes a more sustainable banking model that supports continuous growth.

16. (A) The tendency of financial variables to fluctuate around a trend during the economic cycle
Procyclicality refers to the tendency of financial variables to fluctuate in a way that amplifies the phases of the economic cycle. During booms, credit and asset prices often rise rapidly, while during downturns, they fall sharply. This feedback loop can increase systemic risk. Regulatory measures like capital buffers are designed to dampen these fluctuations and improve financial system resilience.

17. (A) Net Stable Funding Ratio (NSFR)
The liquidity framework prescribes specific monitoring tools such as contractual maturity

ANSWERS

1. (B) 3.5%
Banks other than Domestic Systemically Important Banks must maintain a minimum leverage ratio of 3.5%. This ratio acts as a non-risk-based backstop to protect the banking system from excessive leverage. It ensures that banks maintain sufficient capital relative to their total exposure, regardless of the risk weightings applied to their assets. This promotes overall financial stability and resilience.

2. (C) Level 2A assets are permitted to comprise up to 50% of the total stock of HQLA
Level 2 assets, including Level 2A and Level 2B, are subject to a cumulative cap of 40% of the total stock of high-quality liquid assets. While Level 2A assets are highly liquid, they cannot represent more than this specified limit of the total stock. This ensures the majority of liquid resources remain in the most liquid Level 1 instruments.

3. (C) $\text{LeverageRatio} = \frac{\text{Capital Measure (Tier1Capital)}}{\text{ExposureMeasure}} \geq 3.5$
The Basel III leverage ratio is defined as the capital measure divided by the exposure measure. The capital measure specifically uses Tier 1 capital. This non-risk-based ratio serves as a supplementary measure to risk-based capital requirements. It is designed to constrain the build-up of leverage in the banking sector and provides an additional safeguard for the financial system.

4. (C) Restricting the banking sector from indiscriminate lending in periods of excess credit growth associated with system-wide risk
The broader macro-prudential goal of the counter-cyclical capital buffer is to protect the banking sector from periods of excess aggregate credit growth. By requiring banks to build up capital during boom periods, the regime helps ensure that credit remains available during economic downturns. This mitigates the procyclicality inherent in the financial system and supports long-term economic stability.

5. (B) Transforming short maturities (deposits) into longer maturities (investments) to create funding liquidity
Maturity transformation is a core banking function where short-term liabilities, such as demand and time deposits, are used to fund longer-term assets, like loans and investments. This process creates funding liquidity for the economy but also introduces liquidity risk. Banks must manage this risk carefully to ensure they can meet withdrawal demands from depositors while maintaining their long-term assets.

6. (B) Concentration of funding
Concentration of funding is a liquidity risk monitoring tool designed to identify sources of wholesale funding that are significant enough that their withdrawal could cause liquidity problems. It monitors the bank's reliance on specific counterparties, instruments, or currencies. This helps supervisors evaluate whether a bank's funding profile is sufficiently diversified to withstand stress from specific market segments or providers.

7. (B) Distributable profits before the deduction of elements subject to the restriction on distributions
In the capital conservation buffer framework, earnings are defined as distributable profits before deducting elements subject to distribution restrictions. This includes dividends, share buybacks, and discretionary bonuses. Calculating earnings this way allows regulators to determine the appropriate amount of capital that must be retained based on the bank's current common equity tier 1 capital levels relative to requirements.

8. (B) The assets must be available at all times to be converted into cash and should be unencumbered
High-quality liquid assets must be unencumbered and available at all times for the bank to convert into cash to meet its liquidity needs. This requirement ensures that the assets

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incremental credit-to-deposit ratio, interest coverage ratio, and industry outlook. This multi-indicator approach ensures a comprehensive assessment of systemic risk and credit growth.

26. (D) The amount of available stable funding relative to the amount of required stable funding
The net stable funding ratio is defined as the amount of available stable funding divided by the amount of required stable funding. This ratio must be at least 100% on an ongoing basis. It promotes long-term resilience by requiring banks to fund their activities with sufficiently stable sources of funding over a one-year horizon, thereby reducing future funding risk.

27. (A) The perceived expectation of government support amplifies risk-taking, reduces market discipline, and creates competitive distortions
The perception that certain banks are too big to fail creates an expectation of government support during crises. This expectation can lead to moral hazard, where banks take on excessive risks knowing they might be bailed out. It also reduces market discipline and creates competitive distortions. Regulatory surcharges for systemically important banks aim to address these systemic issues directly.

28. (A) Due to the shifting from services to manufacturing, infrastructure investments, and financial inclusion programs
In a structurally transforming economy like India, credit demand is expected to grow faster than the overall GDP. This is driven by shifts toward manufacturing and infrastructure, which are capital-intensive. Additionally, financial inclusion programs bring more individuals and small businesses into the formal banking system. These factors increase the overall credit intensity, necessitating robust capital planning by banks.

29. (C) Payments which do not result in depletion of Common Equity Tier 1 capital
Under the capital conservation buffer framework, restrictions apply to distributions that deplete common equity tier 1 capital. This includes dividend payments, share buybacks, and discretionary bonus payments. However, payments that do not reduce the bank's common equity tier 1 capital are not subject to these restrictions. This allows banks to continue certain operations without further weakening their core capital.

30. (D) Banks having a size beyond 2% of GDP will be selected in the sample
The methodology for identifying domestic systemically important banks involves selecting a sample of banks based on their size relative to the national economy. Specifically, banks with a total balance sheet size exceeding 2% of GDP are included in the sample for evaluation. Once selected, these banks are assessed based on indicators like size, interconnectedness, substitutability, and complexity.

31. (C) LCR by Significant Currency (BLR-4) — Monthly
The reporting frequencies for Basel III liquidity returns vary by the specific return. The statement on liquidity coverage ratio is reported monthly, while the statement of funding concentration and available unencumbered assets are also monthly. The LCR by significant currency is correctly identified as having a monthly reporting frequency, ensuring timely monitoring of currency-specific liquidity positions by the regulator.

32. (D) (I), (II), (III), (IV), and (V)
High-quality liquid assets possess several key characteristics that ensure their reliability during stress. These include low risk, ease and certainty of valuation, and low correlation with risky assets. They are typically listed on well-established exchanges to ensure transparency. Furthermore, these assets often experience a flight to quality during systemic crises, meaning their relative value tends to remain stable.

33. (B) P-1, Q-2, R-3, S-2
Different categories of high-quality liquid assets are subject to different haircuts. Cash and excess reserves receive a 0% haircut. Marketable securities representing claims on sovereigns with a 20% risk weight receive a 15% haircut. Corporate bonds rated AA- or above also receive a 15% haircut. Common equity shares in major indices are subject to a higher 50% haircut.

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CHAPTER 32
Risk Based Supervision

May/June 2016

1. Arrange the following events related to the bank supervision process in chronological order:

1. The Board for Financial Supervision (BFS) came into being.
2. The Department of Supervision (DoS) was carved out of the DBOD.
3. The Steering Committee for Review of Supervisory Processes submitted its report.
4. Enactment of the Banking Regulation Act.

(A) 4, 2, 1, 3
(B) 4, 1, 2, 3
(C) 2, 1, 4, 3
(D) 1, 2, 3, 4

Oct/Nov 2009

2. Consider the following essential features of an effective bank supervisory framework:

I Being sensitive to evolving macro-economic and regulatory changes.
II Diagnosing the risk profile of each bank clearly.
III Focusing exclusively on domestic branches while ignoring significant lines of business under other regulators.
IV Conducting supervision on a consolidated basis.
V Maintaining an adequate pool of trained supervisory personnel.

Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (V)
(B) (I), (II), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

May/June 2023

3. What necessitated the shift in RBI's approach from intrusive micro-level intervention towards prudential regulation and supervision?
(A) The rapid centralization of banking sector infrastructure during the early 2000s
(B) The decrease in the complexity of banking products and internal bank processes
(C) Liberalization since the 90s, leading to greater operational bank autonomy
(D) The global reduction of cross-border banking activities and trade flow volume

Oct/Nov 2018

4. What does 'Dynamic' off-site supervision imply?
(A) Ensuring the generation of early warning signals for incipient banking risks
(B) Gathering data elements encompassing only the existing risk mitigant factors
(C) Analyzing comprehensive data returns frequently between supervisory cycles
(D) Conducting on-site visits to fill gaps in the information gathered manually

May/June 2007

5. What is the fundamental difference between a compliance-based approach and Risk-Based Supervision (RBS)?
(A) Compliance emphasizes anticipating future risks, whereas RBS evaluates current historical data
(B) Compliance evaluates point-in-time positions, while RBS anticipates future risks
(C) Compliance utilizes historical data flow, while RBS relies only on auditor-certified reports
(D) Compliance is a forward-looking process, while RBS prioritizes current capital rule adherence

Oct/Nov 2025

6. Identify the correct pair regarding the essential attributes of a strong off-site supervisory process:
(A) Extensiveness - Collection of comprehensive data as frequently as possible
(B) Proactive - Being forward-looking and

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a 15% factor. Unencumbered Level 2B assets, representing the lowest tier of high-quality liquid assets, require 50% stable funding.

43. (A) (I), (II), and (IV)
The net stable funding ratio calibration assumes that longer-term liabilities are more stable and that retail deposits are more reliable than wholesale funding. It also assumes that short-dated assets require less stable funding because they can be allowed to mature. However, the framework does not require high-quality assets that can be securitized to be wholly financed with stable funding sources.

44. (A) (I) and (II)
The counter-cyclical capital buffer is activated when the credit-to-GDP gap reaches a lower threshold of 3 percentage points. It reaches its maximum level when the gap hits an upper threshold of 15 percentage points. If the gap is below 3 percentage points, the buffer requirement is 0%, not 0.5%. These thresholds help regulators determine when to moderate credit growth.

45. (B) 2.5% of RWA
In the counter-cyclical capital buffer framework, the required buffer increases as the credit-to-GDP gap rises. The buffer reaches its maximum level when the gap equals or exceeds the upper threshold of 15 percentage points. Since the current gap is 16 percentage points, the bank must maintain the maximum required buffer, which is capped at 2.5% of risk-weighted assets.

46. (B) P-4, Q-2, R-1, S-3
Off-balance sheet items are converted to credit equivalents using specific conversion factors. Direct credit substitutes receive a 100% factor. Commitments with an original maturity up to one year are assigned a 20% factor. Unconditionally cancellable commitments receive a 10% factor. Transaction-related contingencies, such as performance bonds, are assigned a 50% factor. These factors reflect the likelihood of items becoming exposures.

47. (C) Assertion (A) is true, but Reason (R) is false.
While the liquidity coverage ratio is expected to be maintained at 100% or above during normal times, the reason is false because banks are specifically allowed to use their stock of high-quality liquid assets during periods of stress. Supervisors may allow the ratio to fall below 100% to ensure the bank can continue to meet its immediate liquidity obligations.

48. (D) >9.25% to 10.50% — 20%
The capital conservation buffer framework specifies the percentage of earnings a bank must retain based on its common equity tier 1 ratio. As the ratio increases, the required retention percentage decreases. If the ratio is above the buffer range, the required retention is 0%, not 20%. This encourages banks to maintain capital levels above requirements.

49. (A) (I), (II), and (IV)
Available stable funding factors represent the reliability of funding sources. A 100% factor is assigned to total regulatory capital and capital instruments with a residual maturity of one year or more. Other liabilities with a residual maturity of one year or more also receive a 100% factor. Stable retail deposits and operational deposits receive lower factors than 100%.

50. (A) (I) and (II)
To calculate the liquidity coverage ratio, total expected cash outflows are determined by applying run-off rates to various liabilities. Total expected cash inflows are capped at 75% of total expected cash outflows to ensure that the bank maintains a minimum stock of liquid assets. Double counting is strictly prohibited; an asset cannot be counted as HQLA and a cash inflow.

51. (B) ₹ 20,500 million
Calculating the total exposure measure involves adding net on-balance sheet assets, adjusted derivative exposures, securities financing transactions, and credit equivalent amounts of off-balance sheet items. Subtracting deductions from on-balance sheet items and adding the other exposure categories results in a total of 20,500 million. This measure provides a comprehensive view of the bank's total leverage for regulatory purposes.

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Oct/Nov 2005

26. Which of the following is NOT a factor that exposes banks to risks and challenges?
(A) The inherent specificity of banks in the modern economy
(B) The rising volatility of international financial markets
(C) Increased competition and rapid product diversification
(D) Stagnation of global financial market integration

May/June 2020

27. What does 'Proactive' off-site supervision entail?
(A) Forward-looking generation of early warning signals on incipient risks
(B) Collecting data returns between supervisory cycles for historical archiving
(C) Replacing onsite examinations entirely with technological data gathering tools
(D) Restricting supervisory returns to core banking operations and liquidity only

Oct/Nov 2015

28. Consider the following statements regarding the supervisory role of the Department of Banking Supervision:
I Off-site surveillance and ensuring follow-up and compliance.
II Assessing audit performance and disclosure standards.
III Exercising supervisory intervention in the implementation of regulations.
IV Issuing currency notes and managing monetary policy.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV)
(B) (I), (II), and (III)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

May/June 2013

29. Regulatory authorities are examining a financial conglomerate. They assess not only the core banking operations but also the risks posed by its mutual fund and insurance arms, maintaining coordination with the respective sectoral regulators. This action demonstrates which essential feature of an effective supervisory framework?
(A) Ensuring compliance with baseline historical data
(B) Eliminating cross-border banking activities
(C) Conducting supervision on a consolidated basis
(D) Shifting to an intrusive micro-level intervention

Oct/Nov 2021

30. Which of the following is an incorrect characterization of Risk-Based Supervision (RBS)?
(A) It is built around the evaluation of risks and the identification of incipient problems
(B) It rationalizes the use of scarce supervisory resources for high-risk banking areas
(C) It meets the need to deploy resources more efficiently to address identified bank risks
(D) It is a static process quantifying problems through audit-like examination procedures

May/June 2024

31. Match the step in the Supervisory Process (List I) with its corresponding Risk Based Tool (List II):
List I: (Step in Supervisory Process)
P. Understanding the bank
Q. Assessing risks faced by the bank
R. Scheduling and Planning Supervisory Activities
S. Reporting findings and recommendations
List II: (Risk Based Tool)
1. Risk Assessment/Matrix
2. Inspection Reports, Updating of the bank Profile
3. Planning for supervisory actions / interventions
4. Bank Profile
(A) P-1, Q-2, R-3, S-4
(B) P-4, Q-1, R-3, S-2
(C) P-3, Q-4, R-1, S-2
(D) P-2, Q-3, R-4, S-1

Oct/Nov 2008

32. Match the Supervisory Rating Grade (List I) with its corresponding description (List II):
List I: (Supervisory Rating Grade)
P. Good (A)
Q. Satisfactory (B)
R. Unsatisfactory (C)
S. Poor (D)
List II: (Description)

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is applied to the gross amount of derivative liabilities. This is calculated before any netting with derivative assets is considered. For a bank with 800 million in derivative liabilities, the 5% factor results in a required stable funding amount of 40 million for this component.

62. (A) No, because the total aggregated funding exceeds the limit of less than ₹ 5 crore
To be classified as a small business customer under the liquidity coverage ratio disclosure standards in India, the total aggregated funding provided by the customer to the bank must be less than 5 crore. Since the client in this scenario provides 6 crore in funding, they do not meet the criteria, regardless of their annual turnover. They are treated as wholesale.

63. (A) ₹ 340 million
Level 2A assets receive a 15% haircut, so 400 million becomes 340 million. The stock of high-quality liquid assets consists of Level 1 assets plus Level 2 assets, with Level 2 assets capped at 40% of the total. Here, 1,000 million plus 340 million equals 1,340 million. Since 340 is less than 40% of 1,340, the full amount is included.

64. (C) ₹ 4,000 crore
Banks in Bucket 4 of the domestic systemically important banks framework are required to maintain an additional common equity tier 1 capital charge of 0.80% of their risk-weighted assets. For a bank with risk-weighted assets of 5,00,000 crore, the additional capital requirement is calculated as 0.008 multiplied by 5,00,000, which equals exactly 4,000 crore in capital.

65. (B) ₹ 670 crore
The required stable funding is calculated by applying the appropriate factors to each asset. Coins and banknotes receive a 0% factor. Level 1 assets receive a 5% factor, totaling 20 crore. Standard residential mortgages with a maturity over one year receive a 65% factor, totaling 650 crore. The total required stable funding for the given assets is 670 crore.

66. (B) ₹ 1,250 crore
Total net cash outflows are calculated as total expected cash outflows minus the smaller of total expected cash inflows or 75% of those outflows. For Gamma Bank, 75% of 5,000 crore in outflows is 3,750 crore. Since the projected inflows of 4,000 crore exceed this cap, the bank can only offset 3,750 crore. Thus, the total is 1,250 crore.

67. (B) ₹ 100 million
Under the net stable funding ratio framework, off-balance sheet items such as undrawn credit facilities are assigned a required stable funding factor based on their nature. For an unconditionally revocable facility, a 5% factor is applied to the undrawn portion. For a 2,000 million facility, this results in a required stable funding amount of exactly 100 million.

68. (B) ₹ 176.47 million
Using the provided formula for the maximum amount of Level 2B assets, calculate 15/85 multiplied by the sum of adjusted Level 1 and Level 2A assets. The sum of 850 million and 150 million is 1,000 million. Multiplying 1,000 million by approximately 0.17647 results in a maximum permitted Level 2B asset amount of 176.47 million for the stock of liquid assets.

69. (A) ₹ 1,650 crore
Available stable funding is calculated by applying factors to liabilities. Regulatory capital gets a 100% factor, totaling 500 crore. Stable non-maturity retail deposits receive a 95% factor, totaling 950 crore. Funding from non-financial corporate customers with a maturity less than one year receives a 50% factor, totaling 200 crore. Adding these together results in a total of 1,650 crore.

70. (B) 50%
The required stable funding factor for encumbered assets is determined by the duration of the encumbrance. Assets that are encumbered for a period of six months or more but less than one year receive a 50% factor, provided their unencumbered factor is lower than or equal to 50%. Since the retail loans are encumbered for eight months, they qualify.

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52. (D) Bucket 3 — 0.60%
Domestic systemically important banks are categorized into buckets based on their systemic importance scores, with each bucket carrying a specific capital surcharge. Bucket 1 requires a 0.20% surcharge, while Bucket 3 requires 0.60%. These additional common equity tier 1 requirements are expressed as a percentage of risk-weighted assets and must be maintained to increase the loss-absorbency of institutions.

53. (D) Neither (I) nor (II)
The calculation for adjusted high-quality liquid assets involves complex adjustments for securities lending and borrowing, but the specific description provided in the statement is incorrect. Furthermore, repo transactions are not restricted solely to corporate bonds for Level 2 assets. These regulatory definitions are precise and require specific adjustments to ensure the cap on Level 2 assets is correctly applied.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The leverage ratio was introduced as a non-risk-based backstop because many banks that appeared healthy under risk-based measures failed during the financial crisis due to excessive leverage. By using a simple measure of capital against total exposure, the ratio limits the build-up of leverage that risk-based models might fail to capture, thereby enhancing the overall stability.

55. (B) (I), (II), and (III)
Level 1 assets are the most liquid and can be included in the stock of liquid assets without any haircut or limit. These include cash, excess reserves, and government securities held beyond the minimum requirement. Marketable securities from foreign sovereigns with a 0% risk weight also qualify. Corporate bonds, however, are classified as Level 2 assets and subject to haircuts.

56. (A) P-1, Q-2, R-3, S-4
Funding sources are assigned available stable funding factors based on their stability. Total regulatory capital and long-term liabilities receive a 100% factor. Stable non-maturity retail deposits are assigned a 95% factor, while less stable retail deposits receive a 90% factor. Short-term wholesale funding from non-financial corporate customers is considered less stable and is assigned a 50% factor under the framework.

57. (B) 20%
The bank's common equity tier 1 ratio is 6.5%, which is 1.0% above the 5.5% minimum. This puts the bank in the second quartile of the 2.5% capital conservation buffer range. Since 6.5% falls within this specific range, the bank is restricted to a maximum 20% payout of its earnings. This ensures that a majority of profits are retained.

58. (B) Only (II)
The capital conservation buffer is comprised of common equity tier 1 capital, but it is maintained above the minimum common equity requirement, not just the total capital requirement. Statement II is correct as the framework allows banks to continue normal business operations even when capital levels fall into the buffer range, though they must adhere to strict constraints on distributions.

59. (B) (I), (II), and (III)
A 50% required stable funding factor is applied to assets that are moderately liquid. This includes unencumbered Level 2B assets and high-quality liquid assets that are encumbered for six months to one year. Deposits held at other financial institutions for operational purposes also receive this factor. Level 2A assets and short-term claims on the central bank typically receive lower factors.

60. (B) (I) and (II)
The capital measure used for the leverage ratio is Tier 1 capital, consistent with the risk-based capital framework. This measure includes the same regulatory adjustments and deductions as the risk-based Tier 1 capital. However, it does not include Tier 2 capital, as the leverage ratio is designed to measure the most loss-absorbent form of capital against total exposure.

61. (D) ₹ 40 million
Under the net stable funding ratio framework, a specific required stable funding factor of 5%

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ensuring generation of early warning signals
(C) Dynamic - Encompassing all operations including risk elements and mitigants
(D) Interdependent - Initiating statutory audits for historical data verification

May/June 2012

7. What defines the unique position of banks in the economy?
(A) Their ability to operate exclusively in specialized international financial markets
(B) Their role as credit allocators, money creators, and payment system conduits
(C) Their legal exemption from regulatory compliance under the Banking Regulation Act
(D) Their capacity to eliminate all financial risks through maturity transformation

Oct/Nov 2014

8. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer:
Assertion (A): Risk-Based Supervision (RBS) is considered more preventive and forward-looking than compliance-based supervision.
Reason (R): RBS emphasizes understanding and anticipating the possible risks a supervised entity will face when executing its business plan, going beyond its current financial situation.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2019

9. Which of the following is a direct benefit that accrues to a bank from a risk-focused approach to supervision?
(A) Full exemption from external audits and statutory compliance protocols
(B) Early identification of emerging risks at individual and sectoral levels
(C) Complete elimination of operational and credit risks from the system
(D) Primary focus on achieving high profitability margins for shareholders

Oct/Nov 2006

10. Identify the correct pair regarding the entities involved in the bank supervision process:
(A) BFS - Acts as the secretariat for the Department of Banking Supervision
(B) DoS - Created to integrate supervisory and regulatory functions
(C) DBS - Acts as the secretariat of the BFS
(D) RBI Governor - Nominated as the Vice-Chairman of the BFS

May/June 2021

11. Under the RBS regime, how does the focus of on-site visits fundamentally change from traditional supervisory practices?
(A) Focusing entirely on verifying historical financial records via management interviews
(B) Conducting visits strictly to collect raw operational data for later off-site review
(C) Reducing inspections to a simple compliance checklist for capital adequacy ratios
(D) Validating risk aggregates and reviewing gaps found in off-site analysis

Oct/Nov 2010

12. Consider the following statements regarding the supervisory role of the Department of Banking Supervision (DBS):
I It plans for and conducts onsite inspections.
II It determines the criteria for the appointment of statutory auditors.
III It functions as the apex body responsible for the consolidated supervision of the financial sector.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

May/June 2005

13. A banking supervisor is assigned to evaluate a mid-sized commercial bank. Rather than

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34. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The net stable funding ratio is designed to limit overreliance on short-term wholesale funding by encouraging banks to maintain a more sustainable funding structure. This is essential because a stable funding profile reduces the risk of liquidity erosion when regular funding sources are disrupted. Therefore, the goal of the ratio is directly supported by the principle of maintaining long-term resilience.

35. (C) Both (I) and (II)
Under the net stable funding ratio framework, the required stable funding factor for encumbered assets depends on the duration of the encumbrance. Assets encumbered for one year or more require 100% stable funding. Assets encumbered for six months to one year receive a 50% factor if they would have a lower factor when unencumbered. These rules reflect limited liquidity.

36. (C) ₹ 4 Lakh Crore
To be included in the sample for identifying domestic systemically important banks, a bank's size must exceed 2% of the national GDP. With a reported GDP of 200 lakh crore, 2% equals 4 lakh crore. Banks meeting this threshold are automatically selected for a more detailed assessment of their systemic importance using indicators like complexity, substitutability, and interconnectedness.

37. (A) P-2, Q-1, R-3, S-4
The identification of domestic systemically important banks uses four main indicators. Size is measured by total exposure as defined in the leverage ratio. Interconnectedness is assessed through intra-financial system assets and liabilities. Substitutability is evaluated using sub-indicators like assets under custody. Complexity is measured by the notional amount of over-the-counter derivatives. These indicators capture different dimensions of systemic risk.

38. (D) (I), (II), (III), and (IV)
The liquidity coverage ratio stress scenario combines several idiosyncratic and market-wide shocks. These include a partial loss of unsecured wholesale funding and a significant credit rating downgrade. Additionally, it accounts for unscheduled draws on committed credit and liquidity facilities and a run-off of retail deposits. Together, these factors test a bank's ability to withstand a severe thirty-day liquidity crisis.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Counter-cyclical capital requirements are designed to become binding during periods of excessive credit growth to mitigate procyclicality. This is effective because capital requirements act as a buffer and influence the risk-taking behavior of bank management. By increasing capital costs during booms, these requirements provide an incentive for banks to moderate lending, thereby addressing the build-up of systemic risk effectively.

40. (D) Unencumbered SLR Securities — 10%
Unencumbered Statutory Liquidity Ratio securities are generally treated as high-quality liquid assets. Depending on their specific classification under the liquidity coverage ratio, they typically receive a much lower required stable funding factor than 10%. For instance, Level 1 assets often require 0% or 5% stable funding. Assigning a 10% factor to these highly liquid securities is inconsistent with the framework.

41. (B) ₹ 20,500 million
The total exposure measure is calculated by adding on-balance sheet exposures, derivative exposures, securities financing transaction exposures, and off-balance sheet items. Subtracting deductions from on-balance sheet items and adding the other exposure categories results in a total of 20,500 million. This measure provides a comprehensive view of the bank's total leverage, acting as a backstop to risk-based capital requirements.

42. (C) P-1, Q-2, R-3, S-4
Under the net stable funding ratio, assets are assigned factors based on their liquidity. Coins and banknotes require 0% stable funding. Unencumbered Level 1 assets, excluding cash, are assigned a 5% factor. Unencumbered Level 2A assets, which are slightly less liquid, receive

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on a uniform annual audit basis
(D) Segregating the supervisory role from regulatory functions of central banks

May/June 2009

21. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer:
Assertion (A): Considerable time should be spent analyzing off-site data gainfully before embarking on an on-site examination exercise.
Reason (R): Preliminary risk assessment from off-site data provides key inputs to decide on the scope, focus, resources, and time for the onsite supervisory visits.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2011

22. Who chaired the Steering Committee set up in August 2011 to review supervisory processes in respect of commercial banks?
(A) The Governor of RBI
(B) Dr. K. C. Chakrabarty
(C) The Deputy Governor in charge of banking regulation
(D) The head of the Department of Banking Supervision

May/June 2010

23. Read the following statements and select the correct option:
Statement I: The Deputy Governor in charge of banking regulation and supervision is the Chairman of the Board for Financial Supervision (BFS).
Statement II: The Board for Financial Supervision (BFS) normally meets once every year to deliberate supervisory issues.
(A) Both Statement I and Statement II are correct
(B) Both Statement I and Statement II are incorrect
(C) Statement I is correct, but Statement II is incorrect
(D) Statement I is incorrect, but Statement II is correct

Oct/Nov 2024

24. Consider the following statements regarding the benefits of Risk-Based Supervision:
I Improved understanding of the risk profiles of banks and the quality of management.
II Optimum utilisation of supervisory resources with a greater focus on material risks.
III Forward-looking capability to initiate supervisory measures where needed.
IV Automatic restructuring of a bank's business to bring down inherent risks.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (II), (III), and (IV)
(C) (I), (III), and (IV)
(D) (I), (II), and (IV)

May/June 2017

25. Match the supervisory approach (List I) with its corresponding characteristic (List II):
List I: (Supervisory Approach)
P. Compliance-based approach
Q. Risk-Based Supervision
R. Traditional approach
S. Early intervention
List II: (Characteristic)
1. Focuses on identifying poor risk management practices and assessing the quality of risk management systems
2. Focuses on the financial position of the supervised entities at a given point in time (stock)
3. Focuses largely on determining the current financial condition based on historical financial data
4. Prescribed by BCBS to ensure corrective action is initiated before problems undermine safety
(A) P-2, Q-1, R-3, S-4
(B) P-3, Q-4, R-1, S-2
(C) P-1, Q-2, R-4, S-3
(D) P-4, Q-3, R-2, S-1

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merely verifying if the bank meets the current capital adequacy rules, the supervisor assesses whether the bank's upcoming aggressive expansion strategy poses risks that its current management systems cannot handle. Which supervisory philosophy is the supervisor applying?
(A) Risk-Based Supervision
(B) Traditional audit-like examination
(C) Compliance-based supervision
(D) Macro-economic statistical assessment

Oct/Nov 2022

14. Which statement accurately describes the traditional approach to bank supervision?
(A) It focuses on anticipating possible risks when executing business plans beyond the current financial situation
(B) It focuses on identifying poor risk management practices and deploying resources to address identified primary risks
(C) It focuses largely on determining the current financial condition of a bank based on historical financial data
(D) It evaluates risks and identifies incipient problems much before they undermine safety and soundness

May/June 2018

15. A central bank's supervisory department receives data feeds from a commercial bank daily. The department analyzes this data continuously, rather than waiting for the annual review, to adjust its supervisory stance immediately if anomalies appear. This practice exemplifies which specific attribute of off-site supervision?
(A) Extensiveness
(B) Proactive
(C) Static
(D) Dynamic

Oct/Nov 2016

16. Under which legal provisions is the Reserve Bank of India entrusted with the responsibility of supervising the Indian banking system?
(A) The Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934
(B) The Reserve Bank of India Act, 1934 and the Negotiable Instruments Act, 1881
(C) The Banking Regulation Act, 1949 and the Companies Act, 2013
(D) The Foreign Exchange Management Act, 1999 and the Banking Regulation Act, 1949

NODIA

May/June 2014

17. What does 'Extensiveness' in respect of off-site supervision imply?
(A) Encompassing all bank operations including risk elements and mitigants
(B) Generating early warning signals for incipient risks in bank activities
(C) Collecting comprehensive data returns with the highest possible frequency
(D) Performing analysis of data exclusively during scheduled onsite visits

Oct/Nov 2007

18. A newly established non-banking finance company (NBFC) is undergoing an evaluation by the apex body responsible for consolidated supervision of the financial sector. The Governor of RBI is chairing the meeting. Which specific body is conducting this evaluation?
(A) Board for Financial Supervision (BFS)
(B) Department of Banking Supervision (DBS)
(C) Department of Supervision (DoS)
(D) Basel Committee on Banking Supervision (BCBS)

May/June 2025

19. Which of the following is NOT listed as an essential feature of an effective bank supervisory framework?
(A) Assessing compliance with rules and ensuring adherence to safe practices
(B) Ensuring banks maintain appropriate risk management and internal controls
(C) Being highly responsive to emerging risks within individual banking units
(D) Allocating greatest resources to the areas of lowest perceived risk

Oct/Nov 2019

20. What is the key to an effective Risk-Based Supervision (RBS) system?
(A) Evaluating primary risks to ensure efficient and focused resource deployment
(B) Ensuring that the bank has sufficient capital to meet regulatory minimums
(C) Conducting onsite inspections for all banks

1. Probability of failure marginally higher than supervisory comfort
2. Probability of failure is within the acceptable supervisory risk appetite
3. Bank has high probability of failure and needs to raise additional capital
4. Probability of failure is well below the supervisory risk appetite

(A) P-4, Q-2, R-1, S-3
(B) P-2, Q-4, R-3, S-1
(C) P-4, Q-1, R-2, S-3
(D) P-1, Q-2, R-3, S-4

May/June 2006

33. Read the following statements and select the correct option:
Statement I: Onsite inspection under RBS could be used to verify the accuracy of the information submitted by banks as part of regulatory reporting.
Statement II: A thematic review is undertaken strictly as part of baseline monitoring to assess standard compliance rules.
(A) Both Statement I and Statement II are correct
(B) Both Statement I and Statement II are incorrect
(C) Statement I is correct, but Statement II is incorrect
(D) Statement I is incorrect, but Statement II is correct

Oct/Nov 2017

34. The RBI wishes to evaluate the resilience of the entire Indian banking sector against an unexpected 30% crash in the real estate market and a sudden spike in crude oil prices. It conducts an analysis to see if banks have adequate capital buffers for this scenario. What methodology is RBI executing?
(A) Bottom-up baseline monitoring
(B) Micro-level compliance audit
(C) Static historical thematic review
(D) Macro level (top-down) stress testing

May/June 2008

35. Match the Supervisory Stance (List I) with the standard periodicity/nature of its on-site inspection (List II):
List I: (Supervisory Stance)
P. Baseline monitoring
Q. Close monitoring
R. Active oversight
S. Corrective actions
List II: (Nature of Inspection)
1. Yearly on-site inspections covering high/ medium risk areas
2. Onsite inspections on an annual basis under continuous watch
3. Onsite inspections once in two years
4. Onsite supervision only once in three years

(A) P-4, Q-3, R-1, S-2
(B) P-3, Q-4, R-2, S-1
(C) P-4, Q-2, R-1, S-3
(D) P-1, Q-2, R-3, S-4

Oct/Nov 2013

36. The ongoing process of Risk-Based Supervision involves all of the following core steps EXCEPT:
(A) Guaranteeing fixed profitability margins
(B) Profiling the bank
(C) Risk assessment
(D) Planning of supervisory action

May/June 2015

37. Under the Risk-Based Supervision approach, on-site visits should focus on all of the following EXCEPT:
(A) Re-auditing historical financial statements from the previous decade
(B) Filling gaps in information gathered during intensive off-site analysis
(C) Conducting validation checks onsite of the established risk aggregates
(D) Conducting follow-up on issues identified during the previous assessments

Oct/Nov 2012

38. What best characterizes banks falling under 'Close monitoring'?
(A) Robust internal controls requiring onsite supervision once in three years
(B) Material safety concerns necessitating yearly high-risk area inspections
(C) Large-scale threats requiring the commissioning of external specialists
(D) Higher risk to objectives requiring frequent off-site reports

May/June 2011

39. Which statement accurately describes the proposed supervisory rating under RBS?
(A) It measures the total gross operational

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(A) 3, 2, 1, 4
(B) 3, 1, 2, 4
(C) 2, 3, 1, 4
(D) 1, 2, 3, 4

May/June 2021

53. The supervisory stance or intervention of RBI based on the position of the bank in the risk matrix could be one of four categories. Which of the following is NOT one of these categories?
(A) Baseline Monitoring
(B) Close Monitoring
(C) Strategic Restructuring
(D) Active Oversight

Oct/Nov 2010

54. Identify the incorrect pair regarding the Supervisory Rating grades:
(A) Good (A) - Probability of failure is well below the supervisory risk appetite
(B) Satisfactory (B) - Probability of failure is within the acceptable risk appetite
(C) Unsatisfactory (C) - The bank is no longer viable and needs to be wound up
(D) Very Poor (E) - The bank is no longer viable and needs to be wound up

May/June 2005

55. Which statement regarding the 'Corrective actions' supervisory stance is incorrect?
(A) RBI's on-site inspections in such banks would be conducted once in two years
(B) Banks in this zone are considered as posing grave risks to supervisory objectives
(C) The supervisor needs to put these banks under continuous watch
(D) The board of directors may be required to consider resolution options such as restructuring or merger

Oct/Nov 2022

56. What is the main purpose of conducting a thematic review by the supervisor?
(A) Assessing sectoral risks brewing regarding specific products or practices
(B) Evaluating the profitability of a specific bank compared to its global peers
(C) Replacing the annual on-site inspection for banks in the baseline category
(D) Ensuring internal audit mechanisms function without external interference

May/June 2018

57. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer:
Assertion (A): Under the risk-based supervisory approach, stress testing is given a higher weight amongst the analytical toolsets.
Reason (R): Stress tests are forward-looking and dynamic methods capable of identifying threats that may arise from environmental or other financial markets.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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Oct/Nov 2016

58. The Supervisory Relationship Manager (SRM) determines that Bank Theta has a high likelihood of operational collapse. However, because Bank Theta is very small and isolated, its collapse would barely affect the broader financial system. When plotting Bank Theta on the risk assessment matrix, how does the SRM evaluate the twin supervisory objectives?
(A) High probability of failure but low impact of failure
(B) Low probability of failure but high impact of failure
(C) High probability of failure and high impact of failure
(D) Low probability of failure and low impact of failure

May/June 2014

59. The supervisory authorities determine that Bank Omicron is entirely insolvent, its risk profile is unmanageable, and it is no longer a viable entity. The supervisor initiates procedures to merge it with a stable public sector bank. Which supervisory rating accurately reflects Bank Omicron's status?
(A) Grade B
(B) Grade C

Oct/Nov 2018

46. Before initiating an on-site inspection of a bank, the Supervisory Relationship Manager prepares a detailed note. The supervisor shares the scope and focus of the visit with the bank two weeks prior to the visit. What is the primary operational objective of this advance notification?

(A) To allow the bank to alter its risk assessment matrix temporarily for the visit
(B) Ensuring data requirements are met for efficient and disciplined examination
(C) To test the bank's ability to withstand sudden macro-economic stress scenarios
(D) Shifting the burden of transaction testing onto the bank's internal audit team

May/June 2007

47. What is the primary purpose of stress testing within the risk-based supervisory approach?

(A) To verify the historical accuracy of a bank's internal audit records
(B) Determining capital needs and detecting risk management weaknesses
(C) Acting as a backward-looking method to calculate past performance
(D) Replacing the onsite inspection process entirely for high-risk banks

Oct/Nov 2025

48. In the risk assessment matrix under the risk-based approach, the risk to supervisory objectives is determined by combining the probability of failure of the bank and the impact of such a failure. Which formulation accurately represents this determination?

(A) Risk to Supervisory objective = probability of failure + impact of failure
(B) Risk to Supervisory objective = probability of failure × impact of failure
(C) Risk to Supervisory objective = probability of failure / impact of failure
(D) Risk to Supervisory objective = probability of failure - impact of failure

May/June 2012

49. A commercial bank undergoes its annual supervisory risk rating exercise and receives a 'Poor (D)' rating. What immediate restructuring consequence does this rating imply for the bank's business?

(A) Raising capital and restructuring to reduce inherent bank risks
(B) Immediate winding up of the bank as it is no longer viable
(C) Probability of failure is slightly high, requiring thematic review
(D) Operating within risk appetite but needing more off-site reporting

Oct/Nov 2014

50. Identify the incorrect pair linking the supervisory stance to its defining characteristic:

(A) Baseline monitoring - Poses little risk to supervisory objectives
(B) Active oversight - Vulnerable to adverse business and economic conditions
(C) Close monitoring - Stance where systemic impact requires immediate merger or winding up
(D) Corrective actions - Posing grave risks requiring external specialists

May/June 2019

51. Consider the following statements regarding the Core Principles for Effective Banking Supervision:

I Develop a forward-looking assessment of the risk profile of banks.
II Have a framework in place for early intervention.
III Identify risks emanating from banks proportionate to their systemic importance.
IV Ensure banks operate without internal controls to maximize competitive agility.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), and (IV)

Oct/Nov 2006

52. Arrange the first four steps of the ongoing Risk-Based Supervisory framework in the correct sequence:

1. Scheduling and Planning Supervisory Activities
2. Assessing risks faced by the bank for supervisory purpose
3. Understanding the bank
4. Defining Examination Activities, on-site reviews and on-going monitoring

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face in the future. By analyzing how a bank executes its business plan rather than just its current financial state, supervisors can address emerging issues before they threaten institutional stability.

9. (B) Early identification of emerging risks at individual and sectoral levels
A risk-focused supervisory approach provides significant benefits by enabling the early identification of emerging risks at both individual bank and sectoral levels. This early detection allows for timely corrective measures, preventing small issues from becoming systemic crises. It ensures that supervisors and banks can focus their attention on the most critical threats, enhancing the overall resilience of the financial system.

10. (C) DBS - Acts as the secretariat of the BFS
The Department of Banking Supervision performs a crucial administrative role by acting as the secretariat for the Board for Financial Supervision. This board is the apex body responsible for overseeing the financial sector under a consolidated framework. The relationship ensures that supervisory policies formulated by the board are effectively implemented and supported by the technical expertise within the department.

11. (D) Validating risk aggregates and reviewing gaps found in off-site analysis
Under the Risk-Based Supervision regime, the nature of on-site visits changes from traditional audit-like examinations to targeted validation. The primary focus is to validate risk aggregates and address specific gaps identified during intensive off-site analysis. This ensures that on-site resources are used efficiently to investigate high-risk areas rather than performing repetitive checks on well-managed, low-risk banking operations.

12. (A) Only (I) and (II)
The Department of Banking Supervision is responsible for planning and conducting on-site inspections of commercial banks. Additionally, it determines the criteria for appointing statutory auditors to ensure high standards of financial transparency. While it carries out these vital functions, the Board for Financial Supervision serves as the apex body for consolidated supervision, overseeing the broader financial sector.

13. (A) Risk-Based Supervision
When a supervisor evaluates whether a bank's aggressive expansion strategy creates risks that existing management systems cannot handle, they are practicing Risk-Based Supervision. This approach goes beyond checking current rule compliance to anticipate future challenges. It focuses on the quality of risk management systems and the potential impact of strategic business decisions on the institution's future safety and soundness.

14. (C) It focuses largely on determining the current financial condition of a bank based on historical financial data
The traditional approach to bank supervision is largely characterized by a focus on determining a bank's current financial condition using historical data. This method is often point-in-time and compliance-oriented, checking for adherence to existing regulations and capital rules. It lacks the forward-looking perspective necessary to identify and mitigate emerging risks before they impact the bank's overall financial health.

15. (D) Dynamic
The practice of analyzing daily data feeds continuously to adjust the supervisory stance immediately exemplifies the dynamic attribute of off-site supervision. This ensures that the supervisor is not limited to yearly reviews but can respond to anomalies as they occur. Such a frequent and responsive approach allows for a more agile regulatory environment that can adapt to rapid market changes.

16. (A) The Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934
The Reserve Bank of India derives its authority to supervise the Indian banking system from two primary legislative frameworks. The Banking Regulation Act of 1949 and the Reserve Bank of India Act of 1934 provide the legal basis for regulatory and supervisory oversight. These laws empower the central bank to ensure the safety, soundness, and stability of all banking institutions in India.

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(C) Grade D
(D) Grade E

Oct/Nov 2007

60. Bank Zeta is highly vulnerable to adverse economic conditions. Its failure would have a significantly higher impact on financial stability. The supervisor determines that material safety and soundness concerns exist and mandates yearly on-site inspections covering high and medium risk areas. What is the supervisory stance applied to Bank Zeta?
(A) Baseline monitoring
(B) Active oversight
(C) Close monitoring
(D) Corrective actions

May/June 2025

61. During the annual rating exercise, a supervisor concludes that Bank Kappa's probability of failure falls comfortably within the acceptable supervisory risk appetite, but it is not well below it. According to the standard supervisory rating grades, which rating should Bank Kappa receive?
(A) Good (A)
(B) Satisfactory (B)
(C) Unsatisfactory (C)
(D) Poor (D)

Oct/Nov 2019

62. Following a rapid surge in the issuance of unstructured derivative products, the supervisory body decides to execute a specialized assessment focusing exclusively on investment and liquidity risks associated with these derivatives across all commercial banks. This intervention is best classified as:
(A) Thematic review
(B) Baseline monitoring
(C) Continuous off-site surveillance
(D) Corrective action phase

May/June 2009

63. Match the entity or concept (List I) with its corresponding role or definition (List II):
List I: (Entity or Concept)
P. Basel Committee on Banking Supervision (BCBS)
Q. Department of Banking Supervision (DBS)
R. Board for Financial Supervision (BFS)
S. Steering Committee 2011
List II: (Role or Definition)
1. Apex body responsible for Consolidated Supervision of the financial sector
2. Provided an implicit framework via Core Principles for Effective Banking Supervision
3. Discharges the responsibility of supervising the Indian banking system
4. Examined and recommended measures to transform RBI's approach to RBS
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-4, R-2, S-3
(C) P-4, Q-2, R-3, S-1
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2011

64. Which of the following statements is true regarding the Board for Financial Supervision (BFS)?
(A) It was established to regulate only the non-banking finance companies (NBFCs)
(B) It meets once every year to approve the rating of banks
(C) The Deputy Governor in charge of banking regulation and supervision is nominated as its Vice-Chairman
(D) The Department of Banking Supervision acts independently and reports directly to the central government, bypassing the BFS

May/June 2010

65. Regarding the evolution and practices of bank supervision in India, which statement is incorrect?
(A) The BFS came into being in November 1994 to provide oversight.
(B) Shifting the RBI approach toward more intrusive micro-level intervention.
(C) The DoS was carved out of DBOD to segregate supervisory roles effectively.
(D) The Steering Committee chaired by Dr. K. C. Chakrabarty laid the RBS foundation.

Oct/Nov 2024

66. Regarding the Bank Profile maintained under the Risk-Based Supervision framework, consider the following statements:
I It should be updated on an ongoing basis using inputs from various sources.
II It includes information from periodic

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focuses on a bank's financial position at a specific point in time. Risk-Based Supervision evaluates the quality of risk management systems. The traditional approach relies heavily on historical data to determine financial condition, while early intervention is designed to take corrective action before problems undermine an institution's safety.

26. (D) Stagnation of global financial market integration
Modern banks face numerous challenges, including the inherent specificity of their role in the economy and the volatility of international financial markets. Increased competition and rapid product diversification also expose them to various risks. However, the stagnation of global financial market integration is not a factor; rather, it is the increasing integration of these markets that creates complex regulatory challenges.

27. (A) Forward-looking generation of early warning signals on incipient risks
Proactive off-site supervision is characterized by a forward-looking approach that generates early warning signals regarding incipient risks. By identifying potential issues before they manifest as significant problems, supervisors can take preventive actions. This differs from reactive monitoring, as it uses analytical tools and data trends to anticipate vulnerabilities within a bank's operations or the broader financial environment.

28. (B) (I), (II), and (III)
The Department of Banking Supervision is tasked with off-site surveillance and ensuring compliance with regulatory follow-ups. It also assesses audit performance and disclosure standards while exercising supervisory intervention during regulation implementation. While these are core supervisory functions, the issuance of currency notes and the management of monetary policy fall under other departments within the Reserve Bank of India.

29. (C) Conducting supervision on a consolidated basis
When regulatory authorities assess a financial conglomerate by looking at its core banking operations alongside its mutual fund and insurance arms, they are conducting consolidated supervision. This approach ensures that risks across all entities within a group are monitored, even if they fall under different sectoral regulators. Coordination between these regulators is essential to maintain the stability of the entire financial system.

30. (D) It is a static process quantifying problems through audit-like examination procedures
Characterizing Risk-Based Supervision as a static process that uses audit-like examination procedures to quantify problems is incorrect. RBS is actually a dynamic and forward-looking framework designed to identify incipient problems before they escalate. It focuses on evaluating risks and rationalizing the use of supervisory resources, ensuring they are deployed more efficiently to address the most significant threats to stability.

31. (B) P-4, Q-1, R-3, S-2
The ongoing process of Risk-Based Supervision utilizes specific tools at each step. Understanding the bank involves creating a detailed Bank Profile. Assessing risks requires the use of a Risk Assessment Matrix. Scheduling and planning focus on supervisory actions and interventions. Finally, reporting findings results in inspection reports and the updating of the bank's profile to reflect the current risk assessment.

32. (A) P-4, Q-2, R-1, S-3
Supervisory rating grades reflect the probability of a bank's failure. A 'Good' rating indicates failure probability is well below the risk appetite, while 'Satisfactory' means it is within acceptable limits. An 'Unsatisfactory' rating signifies a probability marginally higher than supervisory comfort. A 'Poor' rating is assigned when there is a high probability of failure, necessitating the raising of additional capital.

33. (C) Statement I is correct, but Statement II is incorrect
In a Risk-Based Supervision framework, onsite inspections are used to verify the accuracy of regulatory reporting and information submitted by banks. This ensures data integrity for analysis. However, a thematic review is not strictly part of baseline monitoring; instead, it is a specialized assessment designed to evaluate

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ANSWERS

1. (A) 4, 2, 1, 3
The evolution of bank supervision in India began with the enactment of the Banking Regulation Act in 1949. Later, organizational restructuring led to the creation of the Department of Supervision in 1993, followed by the establishment of the Board for Financial Supervision in 1994. The shift to risk-based supervision culminated with the 2012 Steering Committee report.

2. (B) (I), (II), (IV), and (V)
An effective supervisory framework must adapt to changing macroeconomic environments and regulatory shifts. It requires a clear diagnosis of individual bank risk profiles and consolidated supervision across all business lines. Furthermore, maintaining a pool of trained personnel is vital. Focusing only on domestic branches while ignoring other significant business areas under different regulators is considered an inadequate practice.

3. (C) Liberalization since the 90s, leading to greater operational bank autonomy
Since the 1990s, the Indian banking sector underwent significant liberalization, granting banks greater operational autonomy. This shift moved the regulatory focus away from intrusive micro-level interventions toward a system based on prudential regulation and supervision. This transition ensures that banks maintain financial stability while exercising their independence in a more complex, globally integrated market environment.

4. (C) Analyzing comprehensive data returns frequently between supervisory cycles
Dynamic off-site supervision involves the continuous and frequent analysis of comprehensive data returns submitted by banks. This process occurs between formal supervisory cycles to ensure that the regulatory stance remains current. By monitoring data on a regular basis, supervisors can identify emerging trends or anomalies quickly, allowing for timely interventions and adjustments to the oversight strategy.

5. (B) Compliance evaluates point-in-time positions, while RBS anticipates future risks
Traditional compliance-based supervision primarily evaluates the financial position of a bank at a specific point in time, focusing on historical data and adherence to rules. In contrast, Risk-Based Supervision is a forward-looking approach. It seeks to anticipate future risks that a bank may face when executing its business plan, moving beyond current capital adequacy and financial status.

6. (B) Proactive - Being forward-looking and ensuring generation of early warning signals
A strong off-site supervisory process must be proactive, meaning it is forward-looking and capable of generating early warning signals for incipient risks. This allows supervisors to take action before problems escalate. Other attributes include extensiveness, which covers all operations and risk mitigants, and being dynamic, which involves the frequent analysis of data between regular supervisory cycles.

7. (B) Their role as credit allocators, money creators, and payment system conduits
Banks occupy a unique position in the modern economy because they function as primary credit allocators and money creators. They also serve as essential conduits for the payment system, facilitating the flow of funds across various sectors. This critical role necessitates a robust supervisory framework to maintain financial stability and protect the interests of depositors and the economy.

8. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Risk-Based Supervision is considered more preventive and forward-looking than traditional compliance-based methods. This is because the framework emphasizes understanding and anticipating potential risks an entity might

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discussions with the bank's management.

III It exclusively contains historical financial data without considering off-site surveillance reports.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

May/June 2017

67. Consider the following indicative areas for focused thematic reviews:

I Observance of KYC compliance.
II Management of money laundering risks.
III Approaches for management of interest rate.
IV Exposure to sensitive sectors.
V Pension liability and compensation practices.

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (IV) only
(B) (II), (III), (IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2005

68. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer:

Assertion (A): The Risk-Based Supervision framework meets the supervisor's need to rationalize the use of scarce supervisory resources.

Reason (R): Under RBS, supervisory resources are deployed more efficiently by allocating the greatest resources to the areas of highest risk once primary risks are identified and evaluated.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2020

69. Why does Risk-Based Supervision (RBS) heavily emphasize assessing the quality of a bank's internal risk management systems?

(A) Ensuring appropriate risk control to prevent future insolvency issues
(B) Completely replacing the need for statutory external financial auditors
(C) Ensuring that historical financial returns match bank tax filing records
(D) Qualitative data is mathematically easier to aggregate than quantitative data

Oct/Nov 2015

70. A mid-sized bank displays modest financial conditions and its risk management controls are deemed slightly lacking. The supervisor classifies the bank under 'Close monitoring'. Based on this supervisory stance, what is the mandated frequency for full on-site inspections for this bank?

(A) Once in three years
(B) Once in two years
(C) Yearly
(D) Continuously

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17. (A) Encompassing all bank operations including risk elements and mitigants
Extensiveness in the context of off-site supervision refers to the comprehensive coverage of all bank operations. This includes analyzing various risk elements and the effectiveness of existing mitigants across all business lines. By ensuring a broad scope, supervisors can obtain a holistic view of the bank's risk profile, rather than focusing solely on narrow financial metrics or specific departments.

18. (A) Board for Financial Supervision (BFS)
The Board for Financial Supervision is the apex body responsible for the consolidated supervision of the financial sector in India, including non-banking finance companies. Chaired by the Governor of the Reserve Bank of India, it provides oversight and directions on supervisory matters. Its comprehensive mandate allows it to monitor the entire financial landscape, ensuring stability across diverse types of institutions.

19. (D) Allocating greatest resources to the areas of lowest perceived risk
An effective supervisory framework prioritizes resource allocation based on the level of risk. Therefore, allocating the greatest resources to areas of the lowest perceived risk is contrary to efficient supervision. Instead, resources should be focused on high-risk areas. Essential features include assessing compliance, ensuring robust internal controls, and being highly responsive to emerging risks within individual banking units.

20. (A) Evaluating primary risks to ensure efficient and focused resource deployment
The core of an effective Risk-Based Supervision system lies in evaluating primary risks to ensure that supervisory resources are deployed efficiently and in a focused manner. By identifying the most significant threats to a bank's stability, supervisors can prioritize their efforts where they are most needed. This targeted approach improves the effectiveness of oversight compared to uniform, audit-like examinations.

21. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
It is essential to spend significant time analyzing off-site data before conducting an on-site examination. This preliminary risk assessment provides the necessary inputs to determine the scope, focus, and resources required for the visit. By using off-site data to identify potential problem areas in advance, the on-site process becomes more efficient, disciplined, and targeted toward high-risk activities.

22. (B) Dr. K. C. Chakrabarty
In August 2011, the Reserve Bank of India established a Steering Committee to review supervisory processes for commercial banks. This committee was chaired by Dr. K. C. Chakrabarty, who was then a Deputy Governor of the RBI. The committee's recommendations were instrumental in transforming the Indian supervisory framework into a more robust and forward-looking Risk-Based Supervision system.

23. (B) Both Statement I and Statement II are incorrect
Both statements provided are incorrect regarding the operations of the Board for Financial Supervision. The Governor of the Reserve Bank of India serves as the Chairman, not the Deputy Governor. Furthermore, the board does not meet only once a year; it typically meets every month to deliberate on supervisory issues and provide ongoing direction for the oversight of the financial sector.

24. (A) (I), (II), and (III)
Risk-Based Supervision offers several key benefits, including an improved understanding of bank risk profiles and management quality. It ensures the optimum utilization of supervisory resources by focusing on material risks. Additionally, its forward-looking capability allows for the timely initiation of supervisory measures. However, it does not provide for the automatic restructuring of a bank's business to reduce risks.

25. (A) P-2, Q-1, R-3, S-4
Different supervisory approaches have distinct characteristics. The compliance-based approach

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assets of the banking unit
(B) It provides a formal guarantee against any future banking failures
(C) It determines the exact market share allowed in a financial year
(D) Measuring net risk and conveying the supervisor's risk perception

Oct/Nov 2020

40. Regarding the preparation of a Bank Profile under the RBS framework, consider the following statements:
I It should contain comprehensive yet concise information about the bank.
II It is prepared once and remains unchanged until the bank's risk matrix rating alters.
III It uses inputs from off-site surveillance, management reports, and internal/ external audit findings.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) (I), (II), and (III)

May/June 2022

41. Read the following statements and select the correct option:
Statement I: In a risk-based supervisory framework, both onsite examination and off-site surveillance are mutually independent and do not feed into one another.
Statement II: The effectiveness of a risk-based supervisory process is fundamentally incumbent upon a robust off-site surveillance mechanism.
(A) Both Statement I and Statement II are correct
(B) Both Statement I and Statement II are incorrect
(C) Statement I is correct, but Statement II is incorrect
(D) Statement I is incorrect, but Statement II is correct

Oct/Nov 2023

42. The central bank forms a specialized supervisory team to assess how banks across the entire sector manage exposure to sensitive sectors and compensation practices. This action aims to discern the quantum of risks over a cross-section of banks. This supervisory tool is best described as:
(A) Baseline monitoring
(B) Corrective action
(C) Thematic review
(D) Stress testing

May/June 2016

43. Consider the following actions under the 'Corrective actions' stance:
I Putting the bank under continuous watch.
II Commissioning external specialists to thoroughly assess the loan portfolio.
III Conducting short-duration visits by one/ two officers to verify regulatory returns accuracy only.
IV Seeking a prospective partner for merger, amalgamation, or takeover.
V Conducting RBI's on-site inspections on an annual basis.
Which of the above actions correctly apply to 'Corrective actions'?
(A) (I), (II), (III), and (V)
(B) (I), (II), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (III), (IV), and (V)

Oct/Nov 2009

44. Bank Epsilon is characterized by strong financial health and excellent risk management systems. Its failure would have limited impact on the financial system. It is placed in the Baseline Monitoring zone. What is the regulatory expectation for full onsite supervision of Bank Epsilon?
(A) Once every year
(B) Once in two years
(C) Short-duration visits every six months without full onsite supervision
(D) Once in three years

May/June 2023

45. What is the main objective of macro-level stress testing undertaken by the RBI?
(A) Evaluating specific compensation practices of individual bank executives
(B) Determining day-to-day operational liquidity of a small finance bank
(C) Identifying system-wide threats arising from external financial markets
(D) Reconciling regulatory returns submitted during the previous quarter

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specific risks, products, or practices across a cross-section of the banking sector.

34. (D) Macro level (top-down) stress testing
Conducting an analysis to evaluate how the entire banking sector would withstand extreme but plausible scenarios, such as a real estate crash or oil price spike, is known as macro-level stress testing. This top-down methodology helps the Reserve Bank of India identify system-wide threats and determine if banks have adequate capital buffers to remain resilient under severe economic stress conditions.

35. (A) P-4, Q-3, R-1, S-2
The frequency of on-site inspections is determined by a bank's supervisory stance. Banks under baseline monitoring are inspected once every three years. Those under close monitoring receive inspections once every two years. Active oversight requires yearly inspections focused on high and medium risk areas. Finally, banks requiring corrective actions are put under continuous watch with inspections conducted on an annual basis.

36. (A) Guaranteeing fixed profitability margins
The ongoing process of Risk-Based Supervision involves several core steps, including profiling the bank to understand its business, conducting a comprehensive risk assessment, and planning appropriate supervisory actions. However, the supervisor does not guarantee fixed profitability margins for banks. The regulatory focus is on maintaining safety, soundness, and financial stability, rather than ensuring the commercial success or specific returns of individual institutions.

37. (A) Re-auditing historical financial statements from the previous decade
Under Risk-Based Supervision, on-site visits are targeted and efficient. They focus on filling information gaps identified during off-site analysis, validating established risk aggregates, and following up on previous assessment issues. Re-auditing historical financial statements from the previous decade is not part of this process, as the focus is on current and future risks rather than exhaustive historical audits.

38. (D) Higher risk to objectives requiring frequent off-site reports
Banks categorized under 'Close monitoring' represent a higher risk to supervisory objectives. This stance requires the supervisor to receive more frequent off-site reports to track the institution's performance and risk profile closely. Unlike baseline monitoring, which involves less frequent oversight, close monitoring ensures that potential vulnerabilities are tracked more regularly to prevent them from developing into serious material concerns.

39. (D) Measuring net risk and conveying the supervisor's risk perception
The supervisory rating under the Risk-Based Supervision framework is designed to measure the net risk of a banking institution. It serves as a tool for the supervisor to convey their perception of the bank's risk profile and the adequacy of its risk management systems. This rating is not a guarantee against failure, nor does it determine market share or asset size.

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40. (C) Only (I) and (III)
A Bank Profile is a vital component of Risk-Based Supervision and should contain concise yet comprehensive information about an institution. It is not a static document; rather, it must be updated on an ongoing basis to reflect the current state of the bank. To ensure accuracy, it incorporates diverse inputs, including off-site surveillance data, management reports, and findings from internal and external audits.

41. (D) Statement I is incorrect, but Statement II is correct
In a risk-based supervisory framework, onsite examination and off-site surveillance are not independent; they are deeply interlinked and feed into each other to provide a complete view of a bank's health. The overall effectiveness of the process is fundamentally dependent on having a robust off-site surveillance mechanism. This mechanism provides the preliminary assessments that guide the focus and scope of on-site activities.

42. (C) Thematic review
When a supervisor forms a specialized team to assess specific risks, such as sensitive sector

CHAPTER 33
Risk Based Internal Audit

May/June 2018

1. While attaining the objectives of an effective audit programme, three specific parameters (the three Es) must be followed. Which of the following is NOT one of these parameters?
(A) Efficiency
(B) Effectiveness
(C) Economy
(D) Equity

Oct/Nov 2005

2. A senior branch manager adopts a highly aggressive stance towards internal auditors, treating them with suspicion and aggressively defending his operational territory, effectively deeming his section out of bounds. This scenario represents a breach of which audit foundation?
(A) Valid opinion
(B) Senior management audited
(C) No 'no-go' areas
(D) Sensitive areas audited

May/June 2021

3. What is the conceptual significance of the New Basel Capital Accord in the context of risk management?
(A) It mandates that internal audits must be outsourced to certified external agencies.
(B) It replaces internal control frameworks with strict, non-negotiable regulatory capital caps.
(C) It aligns a bank's maintained capital more closely with its specific risk profile.
(D) It absolves the board of directors from direct oversight of risk management responsibilities.

Oct/Nov 2014

4. How is 'Inherent risk' defined in the context of risk assessment?
(A) The risk of failure of control policies and procedures in detecting a material risky situation or error.
(B) The remaining risk after all effective internal controls have been fully implemented and verified by auditors.
(C) The risk present in a bank's activity in the absence of any mitigation plans or actions by management.
(D) The total potential financial loss arising strictly from sudden macroeconomic and environmental changes.

May/June 2009

5. Consider the following elements typically covered by an internal audit policy:
I Purpose and objectives of the internal audit function.
II Authorities and responsibilities of people involved in the internal audit process.
III Maximum time period beyond which low risk business activities should not remain unaudited.
IV Maintenance of an inventory of all material risks.
V Prescriptive trading limits for the foreign exchange desk.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (IV) only
(B) (I), (III), (IV), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (IV), and (V) only

Oct/Nov 2023

6. Consider the following parameters used in risk assessment:
I Previous internal audit reports and compliance.
II Proposed changes in business lines or change in focus.
III Volume of business and complexity of activities.
IV Political affiliations of the board members.
V Industry trends and other environmental factors.
Which combination represents the correct parameters that should be included in a risk

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monitoring is applied to banks with higher risks that require frequent reporting and biennial inspections. The need for immediate resolution, such as a merger or takeover, is typical of banks in the 'Corrective actions' zone or those receiving the lowest supervisory rating of Grade E.

51. (A) (I), (II), and (III)
The Core Principles for Effective Banking Supervision emphasize a forward-looking assessment of risk profiles and the implementation of an early intervention framework. They also require identifying risks proportionate to a bank's systemic importance. Contrary to maximizing competitive agility without controls, the principles mandate that banks must operate with robust internal control systems to ensure safety and soundness within the financial sector.

52. (A) 3, 2, 1, 4
The Risk-Based Supervisory framework follows a logical sequence. It begins with understanding the bank to create a profile. Next, supervisors assess the specific risks the bank faces. This assessment then informs the scheduling and planning of supervisory activities. Finally, the process involves defining specific examination activities, including on-site reviews and ongoing monitoring, to address the identified risk areas effectively.

53. (C) Strategic Restructuring
Based on a bank's position in the risk matrix, the Reserve Bank of India applies one of four specific supervisory stances: Baseline Monitoring, Close Monitoring, Active Oversight, or Corrective Actions. Strategic Restructuring is not one of these predefined categories, although restructuring might be an outcome of the 'Corrective actions' stance. These categories help the regulator determine the appropriate level of intervention and inspection frequency.

54. (C) Unsatisfactory (C) - The bank is no longer viable and needs to be wound up
Assigning 'Unsatisfactory (C)' to a bank that is no longer viable and needs to be wound up is incorrect. A Grade C rating indicates that the probability of failure is marginally higher than supervisory comfort, but the institution is still considered viable. The classification for a non-viable bank that requires immediate winding up or resolution is 'Very Poor (E)', which represents the highest level of risk.

55. (A) RBI's on-site inspections in such banks would be conducted once in two years
The statement that on-site inspections for banks in the 'Corrective actions' zone are conducted once every two years is incorrect; these inspections are actually performed on an annual basis. Banks in this category are under continuous watch because they pose grave risks to supervisory objectives. Consequently, their boards may be required to consider serious resolution options such as restructuring, mergers, or amalgamations.

56. (A) Assessing sectoral risks brewing regarding specific products or practices
A thematic review is used by supervisors to assess sectoral risks brewing around specific products, practices, or areas of concern, such as KYC compliance or sensitive sector exposure. By examining these themes across multiple banks simultaneously, the supervisor can identify broader trends and systemic vulnerabilities. This targeted approach complements individual bank inspections and helps in formulating sector-wide regulatory responses to emerging threats.

57. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Stress testing is increasingly prioritized within the risk-based supervisory framework because it offers a forward-looking and dynamic perspective. Traditional analytical tools often rely on historical data, but stress tests can identify potential threats from changing environmental conditions or volatility in other financial markets. This capability allows supervisors to evaluate whether a bank's capital and risk management systems can withstand severe future economic shocks.

58. (A) High probability of failure but low impact of failure
In the risk assessment matrix, Bank Theta would be evaluated as having a high probability

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of failure due to its likelihood of operational collapse. However, because its size and isolation mean its failure would not significantly disrupt the broader financial system, it is assessed as having a low impact of failure. This dual evaluation helps the supervisor determine the total risk the bank poses to the overall system.

59. (D) Grade E
Bank Omicron, being entirely insolvent and no longer a viable entity, would be assigned a supervisory rating of Grade E. This rating, also known as 'Very Poor', is reserved for institutions that have failed or are on the verge of failure, necessitating immediate resolution measures such as a merger with a stable bank. It represents the highest possible level of risk to the banking system.

60. (B) Active oversight
Bank Zeta is placed under the 'Active oversight' stance. This is because it is highly vulnerable to adverse conditions and its failure would have a significant impact on financial stability. The supervisor identifies material safety concerns, leading to mandated yearly on-site inspections that focus specifically on high and medium risk areas. This stance ensures that significant risks are monitored closely to maintain institutional and systemic health.

61. (B) Satisfactory (B)
According to standard supervisory rating grades, Bank Kappa should receive a 'Satisfactory (B)' rating. This grade is assigned when a bank's probability of failure falls within the acceptable supervisory risk appetite. While the bank is performing adequately, it does not meet the criteria for a 'Good (A)' rating, which requires the probability of failure to be well below the acceptable risk threshold.

62. (A) Thematic review
A specialized assessment focusing on the investment and liquidity risks of a specific product type, like unstructured derivatives, across all commercial banks is a thematic review. This intervention allows the supervisory body to understand how a particular market trend or product innovation affects the entire sector. It helps in identifying whether certain practices are creating widespread risks that may require new regulatory guidelines or focused oversight.

63. (A) P-2, Q-3, R-1, S-4
Various entities play specific roles in banking supervision. The Basel Committee on Banking Supervision provides the global framework through its Core Principles. The Department of Banking Supervision is responsible for supervising the Indian banking system. The Board for Financial Supervision serves as the apex body for consolidated sector oversight, while the 2011 Steering Committee recommended the transformation to Risk-Based Supervision.

64. (C) The Deputy Governor in charge of banking regulation and supervision is nominated as its Vice-Chairman
The Board for Financial Supervision is a high-level body within the Reserve Bank of India where the Deputy Governor in charge of banking regulation and supervision is nominated as its Vice-Chairman. The board provides oversight for the entire financial sector, not just NBFCs. It meets much more frequently than once a year, and its administrative needs are met by the Department of Banking Supervision.

65. (B) Shifting the RBI approach toward more intrusive micro-level intervention.
The statement regarding the RBI's shift toward more intrusive micro-level intervention is incorrect. In fact, the evolution of bank supervision in India involved moving away from such micro-management toward prudential regulation and Risk-Based Supervision. Other factual milestones include the creation of the Department of Supervision in 1993, the establishment of the BFS in 1994, and the 2011 Steering Committee's work on the RBS framework.

NODIA

66. (A) Only (I) and (II)
The Bank Profile is an essential tool for Risk-Based Supervision and must be updated on an ongoing basis using a variety of inputs. These inputs include periodic discussions with bank management and information from both internal and external audits. It is incorrect to suggest the profile exclusively contains historical data; it must also integrate contemporary findings

from off-site surveillance and other supervisory monitoring activities.

67. (D) (I), (II), (III), (IV), and (V)
Thematic reviews focus on specific areas of interest or concern across the banking sector. These include observance of KYC compliance, management of money laundering risks, and interest rate management approaches. Other focused areas include exposure to sensitive sectors and the evaluation of pension liability and compensation practices. By examining these topics sector-wide, supervisors can ensure consistent standards and identify emerging systemic risks effectively.

68. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Risk-Based Supervision is designed to meet the supervisor's need to rationalize the use of limited resources. This is achieved by deploying personnel and analytical tools more efficiently across the banking sector. Once primary risks are identified and evaluated, the framework ensures that the greatest supervisory resources are allocated to the areas posing the highest risk, rather than using a uniform approach for all institutions.

69. (A) Ensuring appropriate risk control to prevent future insolvency issues
Risk-Based Supervision places a heavy emphasis on assessing the quality of a bank's internal risk management systems to ensure that appropriate controls are in place. Robust internal management is the first line of defense against future insolvency and operational failures. By evaluating these systems, supervisors can determine if a bank is capable of identifying and mitigating its own risks before they escalate into systemic problems.

70. (B) Once in two years
A mid-sized bank classified under 'Close monitoring' due to modest financial health and lacking risk controls will be subject to a full on-site inspection once every two years. This stance is chosen for banks that present a higher risk to supervisory objectives than those in the baseline category. Frequent reporting and more regular on-site visits help the supervisor monitor the bank's efforts to improve its stability.

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(D) Assertion (A) is false, but Reason (R) is true.

May/June 2013

25. Which foundation of audit practice is specifically concerned with providing a comment on the state of internal controls without conjuring up cases against uncooperative officers?
(A) Sensitive areas audited
(B) Unbiased views
(C) Valid opinion
(D) No backing-off

Oct/Nov 2024

26. Which of the following statements correctly reflects the Institute of Internal Auditors' (IIA) definition of internal auditing?
(A) A dependent, subjective assurance activity intended to inspect staff and identify minor operational errors.
(B) A strictly financial checking activity that focuses solely on verifying low-level accounting system entries.
(C) An external consulting function that guarantees absolute control over all identified organizational risks.
(D) An independent, objective assurance and consulting activity designed to improve an organization's operations.

May/June 2011

27. An internal auditor is reviewing the foreign exchange trading desk. The desk generates high profits but operates with an aggressive manager who insists auditors do not understand complex derivatives and thus forbids them from reviewing his specific trading models. The auditor decides not to review the models. This failure directly violates the principle of:
(A) No 'no-go' areas
(B) Systematic approach
(C) Economy of audit
(D) Management reporting

Oct/Nov 2012

28. Who holds the ultimate responsibility for ensuring that an effective system of internal control and an effective internal audit function are in place at the institution?
(A) The Board of Directors and Senior Management
(B) The Chief Risk Officer (CRO)
(C) The External Auditors
(D) The Chief Compliance Officer (CCO)

May/June 2025

29. An internal audit scope is established strictly around basic accounting systems for low-level checking because the audit team lacks the advanced techniques required for higher-level assessments. Consequently, important high-level operations remain unaudited. Which foundation is failing in this scenario?
(A) Impartiality
(B) Unbiased views
(C) Sensitive areas audited
(D) No backing-off

Oct/Nov 2020

30. Identify the incorrect pair regarding functional independence and audit roles.
(A) Chief Risk Officer – Works as an anchor in ensuring internal audit independence.
(B) Internal Audit Department – Independent from the internal control process to avoid conflicts of interest.
(C) Internal Audit Head – Normally reports to the Board of Directors/Audit Committee.
(D) Chief Compliance Officer – Assigned the responsibility of performing core accounting functions.

NODIA

May/June 2017

31. Match the following Risk Matrix categories in List I with their defining conditions in List II:
List I: Risk Matrix Cell
P. Cell A
Q. Cell B
R. Cell C
S. Cell D
List II: Defining Conditions
1. High Inherent Risk, Medium Control Risk
2. Medium Inherent Risk, Low Control Risk
3. High Inherent Risk, Low Control Risk
4. High Inherent Risk, High Control Risk
(A) P-3, Q-1, R-4, S-2
(B) P-1, Q-3, R-2, S-4
(C) P-3, Q-4, R-1, S-2
(D) P-4, Q-1, R-3, S-2

Oct/Nov 2006

32. Consider the following coverage elements in the scope of a Risk-Based Internal Audit:
I Gaps in control mechanism which might

assessment methodology?
(A) (I), (II), (III), and (IV) only
(B) (I), (II), (III), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (III), (IV), and (V) only

May/June 2012

7. What is the fundamental definition of Risk Based Internal Audit (RBIA)?
(A) A mandatory external assessment conducted by third-party consultants to dictate the overall corporate governance framework.
(B) A methodology linking an organization's risk framework to provide assurance on internal control effectiveness.
(C) An internal system specifically designed to eliminate all inherent business risks across diverse banking and financial functions.
(D) A standardized regulatory compliance checklist formulated exclusively for internal use by the Chief Compliance Officer.

Oct/Nov 2019

8. Conceptually, how is 'Objectivity' differentiated from 'Impartiality' in the foundations of audit practice?
(A) Objectivity means refusing to take sides, while impartiality is a psychological state based on emotional detachment.
(B) Objectivity involves evidence-based judgments, while impartiality involves avoiding improper motives or taking sides.
(C) Objectivity relies strictly on regulatory codes, while impartiality relies on internal human resource management policies.
(D) There is no distinction; both terms refer to the process of covertly monitoring staff on behalf of senior management.

May/June 2006

9. An organization can be broken down into auditable units. Which of the following is NOT a standard approach for identifying these audit units?
(A) By function
(B) By employee demographic profile
(C) By transaction type
(D) By geography

Oct/Nov 2011

10. Identify the correct pair of an internal audit concept and its meaning.
(A) Designed to add value – The audit function working for its own mysterious goals independently of the organization.
(B) Improve an organization's operations – The auditors are there primarily to inspect and catch people out.
(C) Evaluate and improve – Setting what is found during an audit against what should be present to ensure good control.
(D) Effectiveness – A top-line concept based on maximising profitability at the expense of control resources.

May/June 2024

11. What is the correct chronological sequence of steps in the risk assessment process for Risk-Based Internal Audit (RBIA)?
I Drawing up a risk-matrix taking into account inherent and control risks.
II Identification of inherent business risks in various activities.
III Evaluation of the effectiveness of the control systems for monitoring inherent risks.
(A) (II)→(I)→(III)
(B) (II)→(III)→(I)
(C) (III)→(II)→(I)
(D) (I)→(II)→(III)

Oct/Nov 2016

12. Consider the following statements regarding the definition of internal audit:
I The primary role is to provide independent assurances that the organization is, or is not, managing risk well.
II Internal audit can give absolute guarantees that controls are able to address all risks.
III The internal audit function is designed to bring a systematic, disciplined approach to evaluate and improve effectiveness.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

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exposure or compensation practices, across a broad cross-section of banks, it is performing a thematic review. This tool allows regulators to identify trends and systemic vulnerabilities related to specific products or management practices that might not be as apparent when looking at individual banks in isolation.

43. (B) (I), (II), (IV), and (V)
The 'Corrective actions' stance involves several intensive measures for banks posing grave risks. These include putting the bank under continuous watch, commissioning external specialists for thorough loan portfolio assessments, and seeking resolution options like mergers or takeovers. Additionally, the RBI conducts annual on-site inspections for these institutions. Short-duration visits to simply verify returns accuracy are more characteristic of lower-risk supervisory stances.

44. (D) Once in three years
Bank Epsilon, characterized by strong financial health and excellent risk management, is placed in the Baseline Monitoring zone because it poses little risk to supervisory objectives. For institutions in this category, the regulatory expectation for a full on-site supervision cycle is once every three years. This allows supervisors to focus more intensive resources on banks that present higher risks to financial stability.

45. (C) Identifying system-wide threats arising from external financial markets
The primary objective of macro-level stress testing conducted by the Reserve Bank of India is to identify system-wide threats that could arise from external financial markets or adverse economic conditions. Unlike micro-level assessments that focus on individual bank practices, these tests evaluate the resilience of the entire banking system. This helps regulators ensure that the collective capital buffers are sufficient to withstand significant economic shocks.

46. (B) Ensuring data requirements are met for efficient and disciplined examination
Providing advance notification of the scope and focus of an on-site visit is an operational strategy used to ensure that all necessary data requirements are met beforehand. This preparation allows for a more efficient and disciplined examination process once the supervisory team arrives. It minimizes delays and ensures that the visit remains focused on the specific risk areas identified during the preliminary off-site analysis.

47. (B) Determining capital needs and detecting risk management weaknesses
Stress testing is a critical tool in the risk-based supervisory approach used to determine a bank's capital needs under adverse conditions. It is a forward-looking method that helps detect potential risk management weaknesses before they lead to actual failures. By simulating various negative scenarios, supervisors can ensure that banks maintain sufficient buffers to survive environmental shocks or sudden market downturns.

48. (B) Risk to Supervisory objective = probability of failure × impact of failure
In the risk assessment matrix, the total risk to supervisory objectives is determined by combining two key factors: the probability that a bank will fail and the impact such a failure would have on the financial system. Mathematically, this is represented as the product of the probability of failure and the impact of failure. This formulation helps supervisors prioritize institutions with both high vulnerability and high systemic importance.

49. (A) Raising capital and restructuring to reduce inherent bank risks
When a bank receives a 'Poor (D)' supervisory rating, it indicates a high probability of failure. Consequently, the bank is required to take immediate action, such as raising additional capital and restructuring its operations to reduce inherent risks. This rating serves as a critical signal that the bank's current business model or financial position is unsustainable without significant intervention to restore its stability.

50. (C) Close monitoring - Stance where systemic impact requires immediate merger or winding up
It is incorrect to characterize 'Close monitoring' as a stance where the systemic impact requires immediate merger or winding up. Close

NODIA

May/June 2019

19. Match the foundations of audit practice in List I with their correct descriptions in List II:
List I: Foundations of Audit Practice
P. Valid opinion
Q. Sensitive areas audited
R. Senior management audited
S. No backing-off
List II: Descriptions
1. Pursuing audit objectives diplomatically despite confronting an assertive manager.
2. Incorporating the management processes that underpin operations into the audit scope.
3. Deriving conclusions properly from work completed to professional standards.
4. Having the necessary skills to cover high-level areas beyond basic low-level checking.
(A) P-3, Q-4, R-2, S-1
(B) P-4, Q-3, R-1, S-2
(C) P-3, Q-2, R-4, S-1
(D) P-2, Q-4, R-1, S-3

Oct/Nov 2008

20. Consider the following statements regarding functional independence:
I The Internal Audit Department must report to the operations managers to ensure seamless integration of controls.
II The Internal Audit Department should be independent from the internal control process to avoid any conflict of interest.
Which of the above statement(s) is/are correct?
(A) (I) only
(B) (II) only
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2020

21. When drawing up a Risk Matrix, into how many categories are inherent business risks and control risks individually classified?
(A) Two (Low and High)
(B) Three (Low, Medium, and High)
(C) Four (Low, Medium, High, and Very High)
(D) Five (Minimal, Low, Medium, High, and Extreme)

Oct/Nov 2021

22. Identify the incorrect statement regarding the nature of internal audits.
(A) Internal audit provides a systematic way for institutions to assess the effectiveness of risk-management.
(B) Internal audit is able to provide absolute guarantees that control systems will prevent any risk materialisation.
(C) Internal auditing cannot survive if it is not objective.
(D) The internal audit service is provided within the organization and is distinct from the external audit role.

May/June 2005

23. Identify the incorrect statement regarding board and management oversight of internal audits.
(A) The audit committee should oversee the internal audit function and evaluate its performance.
(B) The internal audit function should be positioned so that it acts impartially and is not unduly influenced by operation managers.
(C) The board monitors compliance through its audit committee to proactively mitigate risks.
(D) The Chief Audit Officer must have direct responsibility for operating the system of internal control to ensure its effectiveness.

Oct/Nov 2017

24. The following question consists of two statements: one labelled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.
Assertion (A): It is essential that the perceived impartiality of the audit function is maintained to ensure all sides buy into the results.
Reason (R): If an audit function acts like a hit squad looking for material to support original contentions against uncooperative staff, it demonstrates unbiased views.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.

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May/June 2010

13. Which of the following statements correctly describes the foundation of "No spying for management"?

(A) Auditors avoid spying, noting that staff issues often stem from management's failure to implement controls.

(B) Auditors should secretly report non-performing staff directly to the Board of Directors to ensure accountability.

(C) Auditors should strictly avoid communicating with frontline staff to maintain operational and investigative secrecy.

(D) Management must monitor auditors to ensure the internal audit function is providing sufficient organizational value.

Oct/Nov 2025

14. The following question consists of two statements: one labelled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.

Assertion (A): The internal audit function should be positioned so the board has confidence that internal auditors will act impartially.

Reason (R): The Chief Audit Officer must possess full operational responsibility for the systems of internal control to ensure unbiased reporting.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

May/June 2015

15. Consider the following statements regarding the identification of auditable units:

I The corporate assessment of business risk involves capturing key risk elements to isolate and address material control needs.

II Control needs should dictate how much work needs doing and the type of resources most appropriate.

Which of the above statement(s) is/are correct?

(A) (I) only

(B) (II) only

(C) Both (I) and (II)

(D) Neither (I) nor (II)

Oct/Nov 2007

16. Under the proposed Risk-Based Supervision (RBS) approach for banking institutions, what does the supervisory process seek to leverage?

(A) The work done by internal auditors.

(B) The proprietary trading models of the bank.

(C) The external credit rating agency reports.

(D) The administrative policies of the human resources department.

May/June 2022

17. What is the most appropriate reason for ensuring "Senior management audited" as a foundation for audit role and practice?

(A) Because system controls are located in management processes, which must be included to ensure a complete audit.

(B) Because senior managers are statistically more likely to commit minor clerical errors than operational staff.

(C) Because auditing low-level operational staff violates the principle of economy and uses excessive resources.

(D) Because senior management inherently demands higher audit fees and more sophisticated reporting mechanisms.

NODIA

Oct/Nov 2013

18. What is the most appropriate interpretation of a 'Systematic, disciplined approach' in internal auditing?

(A) Applying professional standards and best practice guidelines to deliver high-quality audit services.

(B) Following arbitrary inspection methods that vary based on the specific preference of the audit manager.

(C) Focusing exclusively on identifying and punishing staff members who violate standard operating procedures.

(D) Relying solely on external supervisory mandates instead of developing internal auditing methodologies.

lead to frauds.
II Data integrity, reliability and integrity of MIS.
III Internal, regulatory and statutory compliance.
IV Budgetary control and performance reviews.
Which of the above statement(s) is/are correct as part of the minimum review requirements?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

May/June 2023

33. Based on the overall risk assessment as reflected in a standard risk matrix, consider the following statements:
I High Inherent Risk coupled with Low Control Risk results in a High Risk area.
II Medium Inherent Risk coupled with High Control Risk results in an Extremely High Risk area.
III High Inherent Risk coupled with High Control Risk results in an Extremely High Risk area.
IV Low Inherent Risk coupled with Low Control Risk results in a Low Risk area.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

Oct/Nov 2009

34. An audit team evaluates a new digital lending platform. The line managers believe the unit is low risk because transaction volumes are small. However, the audit team identifies severe underlying vulnerabilities in the algorithmic credit scoring that could lead to massive defaults if scaled. This demonstrates which specific capacity of Risk-Based Internal Audit (RBIA)?
(A) The capacity to dictate operational marketing strategies and customer acquisition for new products.
(B) The specialized capacity to perform external statutory compliance checks for the central bank.
(C) The formal authorization to instantly terminate non-performing line managers and branch staff.
(D) The ability to convert businesses into risks that are weighed for an optimal risk aggregation.

May/June 2014

35. Consider the following statements about transaction testing based on the Risk Matrix:
I Transaction testing is no longer required under the Risk-Based Internal Audit (RBIA) framework.
II A bank should undertake 100% transaction testing if an area falls in Cell C.
III A bank may consider 100% transaction testing if an area falls in Cell B or F and the risks are showing an increasing trend.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

NODIA

Oct/Nov 2018

36. The Board notices a consistent variation between the risk profile as revealed by the internal audit (post-audit) and the risk profile documented in the initial audit plan. What should this observation prompt the Board to do?
(A) Evaluate the reasonableness of the internal audit department's risk assessment methodology.
(B) Terminate the contract of the external auditors immediately for failing to detect variations.
(C) Disregard the variation as a normal outcome of business volatility and operational changes.
(D) Increase the inherent risk rating of all branches globally to ensure maximum safety margins.

May/June 2008

37. What does 'Control risk' refer to?
(A) The risk that control policies and procedures fail to detect and appropriately address a risky situation.
(B) The risk present in an activity when management has not yet implemented any

ANSWERS

1. (D) Equity
The three Es of an effective audit programme consist of efficiency, effectiveness, and economy. Efficiency refers to maximizing output relative to input, effectiveness focuses on achieving defined organizational objectives, and economy relates to minimizing the cost of resources. While equity is a significant governance concept, it is not traditionally classified as one of these three fundamental audit parameters for evaluating performance.

2. (C) No 'no-go' areas
The audit foundation of no 'no-go' areas ensures that every part of an organization remains accessible for internal review. When a manager aggressively defends a section and deems it out of bounds, they create an un-auditable zone. This breach prevents auditors from identifying potential risks or control failures within that territory, thereby undermining the transparency and comprehensive nature of the audit process.

3. (C) It aligns a bank's maintained capital more closely with its specific risk profile.
The New Basel Capital Accord emphasizes a risk-sensitive approach to capital requirements for banking institutions. Its primary significance is ensuring that the capital a bank holds is directly proportional to the specific risks it undertakes. This alignment improves financial stability by encouraging better risk management practices and ensuring that capital serves as a sufficient buffer against potential institutional and systemic losses.

4. (C) The risk present in a bank's activity in the absence of any mitigation plans or actions by management.
Inherent risk represents the raw vulnerability of a business activity before any management interventions or internal controls are applied. It reflects the natural risk level associated with the complexity or volume of specific transactions. Identifying inherent risk is the first step in the assessment process, allowing auditors to establish a baseline for potential issues before evaluating the effectiveness of control measures.

5. (A) (I), (II), (III), and (IV) only
An internal audit policy provides a structural framework for the audit function, detailing its purpose, objectives, and the responsibilities of involved personnel. It should also specify maximum audit intervals for low-risk activities and require a comprehensive inventory of material risks. However, setting prescriptive trading limits for foreign exchange desks is an operational management task rather than a component of the audit policy.

6. (B) (I), (II), (III), and (V) only
Risk assessment methodologies utilize several key parameters, including historical audit performance, changes in business lines, and the complexity of activities. Environmental factors and industry trends are also critical for determining the overall risk profile. While these factors are essential for professional planning, the personal political affiliations of board members are irrelevant and do not constitute a standard parameter in a professional assessment.

7. (B) A methodology linking an organization's risk framework to provide assurance on internal control effectiveness.
Risk Based Internal Audit is a methodology that connects an organization's overarching risk management framework with the internal audit process. It aims to provide the board with independent assurance regarding the effectiveness of internal controls. By focusing on areas with higher risk potential, this approach ensures that audit resources are utilized efficiently to improve organizational governance and manage significant business threats.

8. (B) Objectivity involves evidence-based judgments, while impartiality involves avoiding improper motives or taking sides.
Objectivity and impartiality are distinct foundations in audit practice. Objectivity

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Z operates with High Magnitude and Medium Frequency of risk. Which branch should receive the highest priority among the three?
(A) Branch X
(B) Branch Z
(C) Branch Y
(D) All should receive equal priority regardless of magnitude or frequency.

Oct/Nov 2005

44. According to the Risk Matrix, which combination of risks categorizes an auditable unit as an "Extremely High Risk" area?
(A) Medium Inherent Risk and High Control Risk
(B) High Inherent Risk and Medium Control Risk
(C) Low Inherent Risk and High Control Risk
(D) High Inherent Risk and High Control Risk

May/June 2021

45. The precise scope of risk-based internal audit must be determined by each bank. Which of the following is NOT explicitly mentioned as a standard minimum review requirement?
(A) Data integrity, reliability, and integrity of MIS
(B) Budgetary control and performance reviews
(C) The marketing viability of new financial products
(D) Gaps in control mechanism which might lead to frauds

Oct/Nov 2014

46. Conceptually, what is the role of the internal control framework from a risk management perspective?
(A) Procedures designed to eliminate all inherent business risks entirely across every operational department.
(B) Measures taken by a bank to reduce inherent risk to a level within the bank's established risk appetite.
(C) A specialized framework used to measure the bank's external market risk and credit exposure exclusively.
(D) A set of guidelines that dictate the overarching monetary policy of the central bank and fiscal authorities.

May/June 2009

47. Consider the following statements regarding the communication of audit findings:
I A communication channel between internal audit staff and management should discourage the reporting of sensitive findings to avoid panicking the board.
II Significant issues posing a threat to the bank's business should be promptly brought to the notice of the Board of Directors, Audit Committee, or Top Management.
Which of the above statement(s) is/are correct?
(A) (I) only
(B) (II) only
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2023

48. Which of the following is the correct pair for Cell I in the Risk Matrix?
(A) High Inherent Risk + Low Control Risk → Very High Risk
(B) Low Inherent Risk + High Control Risk → High Risk
(C) Low Inherent Risk + Medium Control Risk → Low Risk
(D) Medium Inherent Risk + Low Control Risk → High Risk

May/June 2012

49. Identify the correct statement regarding Risk Profiles prepared during the conduct of Risk-Based Internal Audit (RBIA).
(A) Risk profiles serve as a Composite Inspection Note which includes the actual risk assessment under various parameters.
(B) Risk profiles are formulated solely by the external auditors to determine the bank's stock price.
(C) Risk profiles are only prepared for branches rated as 'Low Risk'.
(D) Risk profiles exclude any monitorable action plan, focusing only on historical errors.

Oct/Nov 2019

50. The Audit Plan should prioritize audit work to give greater attention to several areas based on magnitude and frequency. Which of

NODIA

(B) The internal audit head normally reports to the Chief Executive Officer directly, bypassing the Board.
(C) The internal audit department reports directly to the external statutory auditors.
(D) The Chief Audit Officer reports to the operation managers to ensure functional independence.

May/June 2020

63. Match the Key Definitions in List I with their concepts in List II:
List I: Key Definitions
P. Risk Based Internal Audit
Q. Risk Matrix
R. Inherent Risk
S. Control Risk
List II: Concepts
1. Risk present in an activity in the absence of mitigation plans.
2. Risk of failure of control policies and procedures in detecting a risky situation.
3. A dynamic analysis tool used for presenting an organization's risk status.
4. An audit methodology linking to the overall risk management framework to provide assurance.

(A) P-4, Q-3, R-1, S-2
(B) P-3, Q-4, R-2, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-1, Q-2, R-4, S-3

Oct/Nov 2021

64. Consider the following activities involved in internal auditing:
I Bringing a systematic, disciplined approach.
II Providing objective assurance and consulting.
III Helping an organization accomplish its objectives.
IV Operating the risk management and governance systems directly.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III) only
(B) (II), (III), and (IV) only
(C) (I), (III), and (IV) only
(D) (I), (II), (III), and (IV)

May/June 2005

65. The Board of Directors of a bank passes a resolution stating that they are transferring all responsibility for having an effective system of internal control exclusively to the Internal Audit Department. Is this resolution valid based on corporate governance principles?
(A) Yes, the Internal Audit Department is inherently responsible for implementing all operational internal controls.
(B) No, the board and senior management are responsible for maintaining an effective system of internal control.
(C) Yes, the Board is only responsible for external audit compliance and reporting to the various shareholders.
(D) No, this responsibility must be exclusively outsourced to the central regulatory authority and oversight body.

Oct/Nov 2017

66. Consider the following statements regarding the independence of the internal audit function:
I The Internal Audit Department should be independent from the internal control process.
II The Chief Audit Officer must take responsibility for operating the internal control systems to ensure their effectiveness.
III The Chief Risk Officer and Chief Compliance Officer work as an anchor in ensuring the internal audit's independence.
Which of the above statement(s) is/are correct?
(A) (I) and (II) only
(B) (I) and (III) only
(C) (II) and (III) only
(D) (I), (II), and (III)

May/June 2013

67. Following a major internal fraud event, an auditor conducts an inspection. To shield his colleagues, the auditor intentionally ignores available evidence that implicates his friends in the operations department, and attributes the fraud to "unforeseen external circumstances." This psychological state fundamentally breaches the audit foundation of:
(A) No 'no-go' areas
(B) Adding value
(C) Assisting management

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Oct/Nov 2025

56. Identify the incorrect statement regarding the categorisation in a typical Risk Matrix.
(A) Cell E (Medium Inherent Risk, Medium Control Risk) indicates a Medium Risk area.
(B) Cell B (High Inherent Risk, Medium Control Risk) indicates a Very High Risk area.
(C) Cell F (Medium Inherent Risk, High Control Risk) indicates a Very High Risk area.
(D) Cell H (Low Inherent Risk, Medium Control Risk) indicates a Medium Risk area.

May/June 2015

57. What is the most appropriate rationale for the Board of Directors/Audit Committee to periodically evaluate the performance of the Risk-Based Internal Audit function?
(A) To assess reliability and objectivity while reviewing variations in the bank's risk profiles.
(B) To determine the exact amount of the annual performance bonus for the Chief Audit Officer.
(C) To strictly reduce the operational cost and overall economy of the internal audit department.
(D) To ensure that the internal auditors take over full responsibility for internal control systems.

Oct/Nov 2007

58. An audit of the credit card processing department reveals that the intrinsic business risk is medium. However, due to recent management changes and inadequate control systems, the risk of control failure is categorized as high. Under which cell does this department fall, and what is the overall risk assessment?
(A) Cell F; Very High Risk
(B) Cell D; Medium Risk
(C) Cell E; High Risk
(D) Cell I; Extremely High Risk

May/June 2022

59. An auditable branch has been consistently rated as "Low Risk" (Cell G) over the past three audit cycles, meaning its routine audit occurs at relatively longer intervals. The audit committee advises a surprise transaction test this year. Does this action conform to general Risk-Based Internal Audit (RBIA) guidelines?
(A) No, low risk areas are entirely exempt from transaction testing.
(B) No, surprise testing is only permitted for Extremely High Risk areas.
(C) Yes, banks may consider transaction testing with an element of surprise in respect of low risk areas audited at longer intervals.
(D) Yes, but only if directed by the external auditor and statutory regulatory body simultaneously.

NODIA

Oct/Nov 2013

60. What is the most appropriate rationale for banks to consider transaction-testing with an element of surprise in respect of low risk areas?
(A) Because low risk areas generate the highest revenue and require aggressive and constant monitoring.
(B) Because these areas have longer audit intervals, surprise testing ensures continuous control maintenance.
(C) To penalize managers of low risk areas for perceived complacency in their operational duties.
(D) To ensure that external auditors can rely on internal findings without performing their own tests.

May/June 2019

61. Identify the incorrect pair of Risk Matrix coordinates and the corresponding risk rating.
(A) Cell D: Medium Inherent Risk, Low Control Risk → Medium Risk
(B) Cell G: Low Inherent Risk, Low Control Risk → Low Risk
(C) Cell E: Medium Inherent Risk, High Control Risk → High Risk
(D) Cell I: Low Inherent Risk, High Control Risk → High Risk

Oct/Nov 2008

62. Identify the correct statement regarding the structural reporting lines of an internal audit department.
(A) The internal audit head should normally report to the Board of Directors/Audit Committee of the Board.

This approach promotes efficiency and ensures that supervisory oversight is well-integrated with the bank's existing risk management and internal control frameworks.

17. (A) Because system controls are located in management processes, which must be included to ensure a complete audit.
Auditing senior management is a critical foundation because vital system controls are often embedded within management-level processes. A complete and effective audit must include these levels to ensure that the entire governance structure is functioning correctly. Excluding senior management would leave significant strategic and operational risks unmonitored, thereby weakening the overall internal control environment and the integrity of the institution.

18. (A) Applying professional standards and best practice guidelines to deliver high-quality audit services.
A systematic and disciplined approach in internal auditing involves the rigorous application of professional standards and best practice guidelines. This ensures that audit services remain consistent, reliable, and high-quality across the entire organization. By following a structured methodology instead of arbitrary methods, auditors can provide an accurate and comprehensive assessment of risk management, control systems, and broader corporate governance processes.

19. (A) P-3, Q-4, R-2, S-1
Different foundations support effective audit practice through distinct roles. A valid opinion is derived from work meeting professional standards. Sensitive areas require specialized skills for high-level reviews. Auditing senior management incorporates management processes into the audit scope. Finally, no backing-off involves diplomatically pursuing objectives when faced with assertive managers. These principles collectively ensure a robust, comprehensive, and professional internal audit function.

20. (B) (II) only
Functional independence requires the internal audit department to be independent of the internal control processes it evaluates. This separation prevents conflicts of interest and ensures unbiased reporting. While auditors must understand operational workflows, they should not report to operations managers. Instead, they must report to higher governance bodies like the audit committee to maintain their objective status within the organizational structure.

21. (B) Three (Low, Medium, and High)
When developing a risk matrix, inherent business risks and control risks are each classified into three distinct categories: low, medium, and high. By plotting these assessments on a grid, the organization can determine a composite risk rating for a specific unit. This three-tiered classification provides a clear and manageable framework for prioritizing audit activities and resources based on the identified risks.

22. (B) Internal audit is able to provide absolute guarantees that control systems will prevent any risk materialisation.
Internal auditing provides a systematic method for assessing risk management and must remain objective to be successful. It is an internal function distinct from external auditing. However, it cannot provide absolute guarantees that control systems will prevent all risk materialization. The goal is to offer reasonable assurance regarding the adequacy of controls and to identify areas for improvement within the environment.

23. (D) The Chief Audit Officer must have direct responsibility for operating the system of internal control to ensure its effectiveness.
Board and management oversight is critical, with the audit committee monitoring compliance and evaluating the internal audit function. However, the Chief Audit Officer should not be responsible for operating internal control systems. Direct operational responsibility would compromise the independence and impartiality necessary for the audit head to provide an unbiased and objective assessment of those systems to the board.

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(D) Objectivity

Oct/Nov 2024

68. Identify the incorrect statement regarding the application of the Risk Matrix in audit planning.

(A) An area falling in Cell G (Low Inherent Risk, Low Control Risk) mandates immediate 100% transaction testing.

(B) Areas identified as high, very high or extremely high risk may be audited at shorter intervals.

(C) Medium or low risk areas may be audited at longer intervals subject to regulatory guidelines.

(D) The Risk Matrix should be prepared for each business activity/location.

May/June 2011

69. A multinational bank wants to understand the overarching risks associated with its letter of credit operations. Instead of auditing branch by branch, it decides to audit the letter of credit operations collectively across all its global locations. Which option for identifying auditable units does this represent?

(A) By function

(B) By transaction type

(C) By geography

(D) By compliance mandate

Oct/Nov 2012

70. A bank launches a new derivative trading desk. The intrinsic nature of derivative trading places it in the high inherent risk category. However, top management implements state-of-the-art AI-driven monitoring routines, thereby keeping the control risk low. According to the standard Risk Matrix, in which cell does this trading desk fall, and what is its overall risk rating?

(A) Cell B; Very High Risk

(B) Cell A; High Risk

(C) Cell C; Extremely High Risk

(D) Cell D; Medium Risk

NODIA

the following is NOT one of those prioritized combinations?
(A) High Magnitude and high frequency
(B) High Magnitude and medium frequency
(C) Low Magnitude and low frequency
(D) Medium Magnitude and high frequency

May/June 2006

51. Consider the following areas of review for Risk-Based Internal Audit (RBIA):
I The control environment in various areas.
II Internal, regulatory and statutory compliance.
III Transaction testing/verification of assets to the extent considered necessary.
IV Monitoring compliance with the risk-based internal audit report.
V Variation in the assessment of risks under the audit plan vis-à-vis the actual audit.
Which of the above statement(s) is/are correct as part of the minimum areas to be reviewed?
(A) (I), (II), and (III) only
(B) (I), (III), (IV), and (V) only
(C) (II), (III), (IV), and (V) only
(D) (I), (II), (III), (IV), and (V)

Oct/Nov 2011

52. Match the following Risk Matrix Cells in List I with their corresponding Risk Levels in List II:
List I: Risk Matrix Cells
P. Cell E
Q. Cell F
R. Cell G
S. Cell H
List II: Risk Levels
1. Very High Risk
2. Low Risk
3. Medium Risk
4. High Risk
(A) P-4, Q-1, R-2, S-3
(B) P-1, Q-4, R-3, S-2
(C) P-3, Q-1, R-2, S-4
(D) P-4, Q-2, R-1, S-3

May/June 2024

53. A banking department categorised in Cell B (Very High Risk) has been monitored over three successive quarters. The inherent and control risks are showing an increasing trend. What action is required in such a scenario?
(A) Shifting the audit cycle to a longer interval to allow management time to fix control issues.
(B) Maintaining the standard audit schedule without implementing any additional ongoing monitoring.
(C) Immediate audit attention, resource allocation, and ongoing monitoring by top management.
(D) Reclassifying the department to Cell A automatically regardless of the actual risk trend.

Oct/Nov 2016

54. The following question consists of two statements: one labelled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.
Assertion (A): In the case of branches with a composite risk rating of 'Extremely High/ Very High', the risk profiles should be sent along with the audit report immediately to the Inspection & Audit Department in the Head Office.
Reason (R): Immediate communication is required because these branches pose a significant threat to the bank's business and require prompt Top Management/Board attention to mitigate systemic risks.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2010

55. Based on the Risk Audit Matrix, consider the following priorities for audit work:
I Medium Magnitude and high frequency
II High Magnitude and high frequency
III High Magnitude and medium frequency
Identify the correct chronological order of priority (from highest priority to lowest):
(A) (II) → (I) → (III)
(B) (II) → (III) → (I)
(C) (III) → (II) → (I)
(D) (I) → (II) → (III)

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requires auditors to make judgments based on factual evidence and professional standards rather than personal feelings. Impartiality specifically refers to the psychological state of being free from bias or improper motives when evaluating findings. Together, they ensure that the audit process remains fair and that conclusions are reached without prejudice.

9. (B) By employee demographic profile
Identifying auditable units involves dividing an organization into manageable segments based on logical structures. Common approaches include categorizing units by function, transaction type, or geography. These methods allow for a comprehensive review of operational risks. However, the demographic profile of employees is not a standard or recognized method for defining audit units, as it does not reflect the operational or risk-based structure.

10. (C) Evaluate and improve – Setting what is found during an audit against what should be present to ensure good control.
The concept of evaluate and improve involves comparing actual findings against established standards to ensure robust control within an organization. This systematic approach identifies gaps and suggests enhancements for better operations. Unlike mere inspections intended to catch errors, this core concept focuses on adding long-term value and assisting the institution in achieving its strategic objectives through a disciplined and professional review.

11. (B) (II) → (III) → (I)
The chronological sequence for risk assessment in a risk-based audit begins with identifying inherent business risks across various activities. Next, the effectiveness of existing control systems for monitoring those specific risks is evaluated. Finally, a risk matrix is drawn up by combining inherent and control risk assessments. This structured approach ensures that the audit plan is prioritized based on the overall risk.

12. (C) (I) and (III) only
Internal audit provides independent assurance on whether an organization is managing its risks effectively. It uses a systematic, disciplined approach to evaluate and improve governance and control processes. While it offers a high level of assurance, it cannot provide absolute guarantees that all risks will be addressed. Therefore, the function focuses on providing reasonable assurance to the board regarding the internal control environment.

13. (A) Auditors avoid spying, noting that staff issues often stem from management's failure to implement controls.
The foundation of no spying for management establishes that auditors are not surveillance tools for leadership. It recognizes that many staff-level issues arise from management's failure to provide adequate guidance or implement proper controls. By avoiding a spying role, auditors maintain their professional integrity and focus on systemic improvements rather than acting as a punitive force targeting individuals on behalf of management.

14. (C) Assertion (A) is true, but Reason (R) is false.
The internal audit function must be positioned to ensure the board perceives it as impartial. However, the Chief Audit Officer should not have operational responsibility for internal control systems. Having such responsibility would create a significant conflict of interest and undermine the auditor's ability to report on those controls without bias. Independence is preserved by separating the audit function from daily operational management.

15. (C) Both (I) and (II)
Identifying auditable units requires a thorough corporate assessment of business risks to isolate material control needs. These identified needs then determine the volume of work required and the appropriate resources for the audit. Both statements are correct because the scope and intensity of the internal audit process must be driven by the risk profile and necessary control levels within each specific business unit.

16. (A) The work done by internal auditors.
Under the Risk-Based Supervision approach, regulators seek to leverage the work performed by a bank's internal auditors. This coordination allows supervisors to focus on significant institutional risks while utilizing the detailed findings from the bank's own internal reviews.

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formal mitigation plans.
(C) The intrinsic risk in a particular business area grouped into specific severity and impact categories.
(D) The risk associated with global regulatory changes over which the bank has no direct oversight or control.

Oct/Nov 2010

38. Match the coordinates on the Risk Audit Matrix in List I with their corresponding classifications in List II:
List I: Risk Audit Matrix Coordinates
P. High Magnitude, High Frequency
Q. Low Magnitude, High Frequency
R. High Magnitude, Low Frequency
S. Medium Magnitude, Medium Frequency
List II: Classifications
1. Low M, High F
2. High M, High F
3. Medium M, Medium F
4. High M, Low F
(A) P-2, Q-1, R-4, S-3
(B) P-1, Q-2, R-3, S-4
(C) P-4, Q-3, R-2, S-1
(D) P-2, Q-4, R-1, S-3

May/June 2016

39. Conceptually, what is the primary purpose of the Monitorable Action Plan included in the Risk Profile?
(A) To provide a daily checklist for frontline cashiers.
(B) To record the attendance and performance appraisals of branch managers.
(C) To serve as a marketing tool for acquiring new institutional clients.
(D) To suggest actions by the auditors for mitigating identified risks.

Oct/Nov 2022

40. A specialized trading unit within a bank exhibits an intrinsic risk that represents a worst-case scenario due to complex derivative exposures. Simultaneously, the latest examination report notes severe gaps and likely failures in the existing control processes of this unit. Consequently, the unit falls into Cell C. What minimum level of transaction testing should the bank consider for this unit?
(A) Transaction testing at random intervals.
(B) 50% transaction testing.
(C) Transaction testing only for low-value trades.
(D) 100% transaction testing.

May/June 2007

41. A bank operates a highly volatile equity trading desk (Inherent Risk is high). The bank's management institutes rigorous automated stop-loss systems, daily reconciliations, and independent trade verifications. As a result, the risk profile of this desk is well within the bank's risk appetite. From a risk management perspective, what does this scenario illustrate?
(A) Inherent risk eliminating control risk entirely.
(B) Internal control acting as measures taken to bring down the inherent risk.
(C) The failure of the audit policy to identify auditable units.
(D) Control risk overpowering the inherent business risk.

Oct/Nov 2015

42. The following question consists of two statements: one labelled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.
Assertion (A): An auditable unit falling in Cell C of the Risk Matrix requires immediate audit attention and maximum allocation of audit resources.
Reason (R): Cell C represents an Extremely High Risk area where both inherent business risk and control risk are high.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2018

43. During the annual audit planning, a bank identifies three branches. Branch X operates with High Magnitude and Low Frequency of risk. Branch Y operates with Medium Magnitude and High Frequency of risk. Branch

NODIA

24. (C) Assertion (A) is true, but Reason (R) is false.
Maintaining the perceived impartiality of the audit function is vital for stakeholders to trust and act upon the results. If an audit function acts as a hit squad seeking material against specific staff, it demonstrates bias rather than professional neutrality. Such behavior contradicts the core principles of auditing. Therefore, while impartiality is essential, punitive or biased approaches damage the function's credibility.

25. (B) Unbiased views
The foundation of unbiased views involves providing an objective comment on the state of internal controls without targeting specific individuals or groups. It ensures that the audit focus remains on systemic issues and control effectiveness rather than building cases against uncooperative officers. This approach helps maintain professional relationships and ensures that findings are based on facts and fair evaluation of processes.

26. (D) An independent, objective assurance and consulting activity designed to improve an organization's operations.
The Institute of Internal Auditors defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve operations. It utilizes a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. This definition highlights the proactive and constructive nature of modern internal audit in helping institutions achieve their goals.

27. (A) No 'no-go' areas
The principle of no 'no-go' areas dictates that auditors must have access to all parts of an organization, including complex or high-profit units. When an auditor allows a manager to exclude specific trading models from a review, they fail to uphold this principle. This omission creates a significant risk gap, as unexamined areas can harbor undetected vulnerabilities or serious control failures.

28. (A) The Board of Directors and Senior Management
The Board of Directors and senior management hold the ultimate responsibility for ensuring that an effective internal control system and audit function are in place. While auditors provide assurance, the accountability for establishing the framework and responding to findings lies with the highest levels of leadership. This responsibility is a central pillar of sound corporate governance and institutional risk management.

29. (C) Sensitive areas audited
The foundation of sensitive areas audited is compromised when an audit team lacks the advanced techniques required for high-level assessments. If the scope is limited to basic accounting checks while complex operations remain unexamined, the organization is exposed to significant risks. Auditors must possess the necessary skills to cover all sensitive and critical parts of the business effectively and professionally.

30. (D) Chief Compliance Officer – Assigned the responsibility of performing core accounting functions.
Functional independence requires a clear separation of roles. While the Chief Risk Officer helps anchor audit independence and the audit department is separate from control processes, the Chief Compliance Officer should not perform core accounting functions. Such an assignment would mix compliance oversight with operational duties, potentially creating conflicts of interest and undermining the integrity of the institution's control framework.

31. (A) P-3, Q-1, R-4, S-2
In a standard risk matrix, specific cells represent different risk combinations. Cell A reflects high inherent risk with low control risk. Cell B indicates high inherent risk with medium control risk. Cell C corresponds to high inherent risk and high control risk. Cell D represents medium inherent risk with low control risk. These classifications are essential for determining the necessary audit intensity.

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32. (D) (I), (II), (III), and (IV)
The scope of a risk-based internal audit includes several critical review requirements. These encompass evaluating control mechanism gaps, ensuring MIS data integrity, and checking compliance with regulatory mandates. Additionally, budgetary controls and performance reviews are essential components. Together, these elements provide a comprehensive assessment of the organization's risk and control environment, forming the minimum requirements for a robust internal audit function.

33. (B) (I), (III), and (IV) only
A risk matrix determines the overall risk rating based on inherent and control risks. High inherent risk paired with low control risk results in a high-risk area. Conversely, high inherent risk with high control risk creates an extremely high-risk area. Low inherent risk with low control risk is categorized as low risk. These combinations guide auditors in prioritizing their work effectively.

34. (D) The ability to convert businesses into risks that are weighed for an optimal risk aggregation.
Risk Based Internal Audit has the specialized capacity to convert complex business activities into quantifiable risks. These risks are then weighed to allow for an optimal aggregation of the organization's risk profile. In the case of a new platform, RBIA identifies underlying vulnerabilities that managers might overlook, ensuring that the true risk potential is accurately assessed and addressed by top management.

35. (B) (II) and (III) only
Transaction testing remains a vital part of the internal audit framework. If an area falls into Cell C, 100% transaction testing should be undertaken due to the high risk level. Similarly, if areas in Cell B or F show an increasing risk trend, full testing may also be considered. This ensures that controls are functioning as intended and data remains accurate.

36. (A) Evaluate the reasonableness of the internal audit department's risk assessment methodology.
When the actual risk profile found during an audit differs significantly from the initial plan, the Board must take action. This variation suggests that the underlying risk assessment methodology may be flawed or outdated. Evaluating the reasonableness of the methodology ensures that future audit plans are more accurate and that the bank's resources are directed toward genuine risks within the organization.

37. (A) The risk that control policies and procedures fail to detect and appropriately address a risky situation.
Control risk refers to the potential that existing policies and procedures will fail to detect or appropriately address a risky situation or error. It measures the effectiveness of the bank's internal mitigation efforts. Unlike inherent risk, which is natural to the activity, control risk highlights weaknesses in management's designed safeguards, requiring auditors to evaluate the strength of the internal control environment.

38. (A) P-2, Q-1, R-4, S-3
The risk audit matrix prioritizes work based on the magnitude and frequency of potential risks. High magnitude and high frequency represent the highest priority (Cell P-2). Low magnitude and high frequency involve frequent but smaller issues (Cell Q-1). High magnitude and low frequency concern rare but impactful events (Cell R-4). Medium magnitude and frequency fall in between (Cell S-3).

NODIA

39. (D) To suggest actions by the auditors for mitigating identified risks.
The Monitorable Action Plan is a critical component of the Risk Profile. Its primary purpose is to suggest specific actions to be taken for mitigating identified risks. By providing a clear roadmap for addressing control gaps, the plan ensures that audit findings lead to tangible improvements in the organization's risk management and operational security, facilitating better oversight by top management.

40. (D) 100% transaction testing.
A unit falling into Cell C of the risk matrix represents an area with high inherent risk and significant control gaps. Given the high magnitude and likely failure of existing controls in complex derivative trading, the bank should

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consider 100% transaction testing. This intensive review is necessary to ensure that all transactions are valid and that risks are managed within limits.

41. (B) Internal control acting as measures taken to bring down the inherent risk.
Internal controls serve as the measures management takes to reduce inherent risks to acceptable levels. In this scenario, the volatile trading desk has high inherent risk, but the implementation of rigorous automated systems and independent verifications brings the risk within the bank's appetite. This demonstrates how effective control frameworks successfully mitigate the natural vulnerabilities associated with high-risk business activities and desks.

42. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Cell C in the risk matrix is categorized as an extremely high-risk area because it combines high inherent business risk with high control risk. Due to this severe risk level, any auditable unit in this cell requires immediate attention and the maximum allocation of audit resources. This prioritized response is essential to address the significant threat these units pose to the institution.

43. (C) Branch Y
In prioritizing audit work, units with high frequency are typically addressed first to manage constant risk exposure. Branch Y, with medium magnitude but high frequency, should receive higher priority among the choices. While magnitude is important, frequent risks can indicate systemic control failures. A balanced approach ensures that both impact and occurrence are considered when developing the overall audit plan.

44. (D) High Inherent Risk and High Control Risk
An "Extremely High Risk" area is defined by the combination of high inherent risk and high control risk. This means the business activity is naturally very risky, and existing internal controls are insufficient to manage that risk effectively. Identifying these areas is crucial for auditors, as they represent the most significant potential threats to the organization's stability and require immediate resource allocation.

45. (C) The marketing viability of new financial products
Standard minimum review requirements for a risk-based internal audit include evaluating control gaps, ensuring MIS data integrity, and reviewing budgetary performance. While marketing is important for growth, evaluating the marketing viability of new financial products is not an explicit part of the standard internal audit review scope. Audit focuses on control, compliance, and risk management rather than the commercial success of products.

46. (B) Measures taken by a bank to reduce inherent risk to a level within the bank's established risk appetite.
From a risk management perspective, the internal control framework consists of measures taken by a bank to mitigate inherent risks. The goal is to bring these risks down to a level that resides within the bank's established risk appetite. It is not intended to eliminate risk entirely but to manage it effectively so the institution can operate safely and meet its goals.

47. (B) (II) only
Effective communication in auditing requires that significant issues posing a threat to the bank's business are promptly brought to the notice of the board and top management. Transparent reporting ensures that leadership can take timely action to mitigate risks. Discouraging the reporting of sensitive findings would be a failure of the audit function, as it prevents the board from fulfilling oversight responsibilities.

48. (B) Low Inherent Risk + High Control Risk → High Risk
Cell I in the risk matrix represents a combination of low inherent risk and high control risk. Despite the low natural risk of the activity, the lack of effective controls elevates the overall risk assessment to a high level. This classification emphasizes that even simple operations can become risky if they are not supported by a robust and functioning internal control environment.

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49. (A) Risk profiles serve as a Composite Inspection Note which includes the actual risk assessment under various parameters.
Risk profiles prepared during a Risk-Based Internal Audit act as a composite inspection note. They provide a comprehensive record of the actual risk assessment across various parameters and include a monitorable action plan. This document is essential for summarizing findings and ensuring that management has a clear understanding of the risks identified and the steps required for their mitigation.

50. (C) Low Magnitude and low frequency
Audit plans prioritize work based on combinations of magnitude and frequency of risk. High magnitude with high or medium frequency, and medium magnitude with high frequency, are all priority areas. However, low magnitude and low frequency represent the lowest risk level and do not require prioritized attention. Focusing on higher-risk combinations ensures that limited audit resources are used most effectively.

51. (D) (I), (II), (III), (IV), and (V)
The minimum areas for review in a risk-based internal audit are comprehensive. They include evaluating the control environment, regulatory compliance, and performing necessary transaction testing. Additionally, auditors must monitor compliance with previous reports and assess any variations between the audit plan's risk assessment and actual findings. These elements together ensure a thorough and effective review of the bank's operations.

52. (A) P-4, Q-1, R-2, S-3
Each cell in the risk matrix corresponds to a specific risk level based on inherent and control risk. Cell E maps to high risk, Cell F to very high risk, Cell G to low risk, and Cell H to medium risk. Understanding these classifications is vital for auditors to plan their schedules and determine the appropriate depth and frequency of their investigations.

53. (C) Immediate audit attention, resource allocation, and ongoing monitoring by top management.
When a department in a very high-risk category shows an increasing risk trend, it requires immediate attention. Top management must allocate more resources and implement ongoing monitoring to address the deteriorating situation. Lengthening the audit cycle or ignoring the trend would be inappropriate, as it would leave the organization exposed to escalating risks that could lead to significant failures.

54. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Branches with extremely high or very high risk ratings pose significant threats to a bank's business. Therefore, their risk profiles must be sent immediately to the Head Office and top management along with the audit report. This rapid communication ensures that the Board can take prompt action to mitigate systemic risks and protect the institution from potential material losses or failures.

55. (B) (II) → (III) → (I)
The highest priority in audit work is given to areas with high magnitude and high frequency of risk. The next priority is high magnitude and medium frequency, followed by medium magnitude and high frequency. This order ensures that the most impactful and frequent risks are addressed first. By following this sequence, auditors can systematically reduce the bank's exposure to critical threats.

56. (A) Cell E (Medium Inherent Risk, Medium Control Risk) indicates a Medium Risk area.
In a standard risk matrix, the overall risk rating is derived from the combination of inherent and control risks. While Cell B and F represent very high risk and Cell H represents medium risk, the classification for Cell E is different. Cell E, involving medium inherent and medium control risk, actually indicates a high-risk area rather than a medium-risk one.

57. (A) To assess reliability and objectivity while reviewing variations in the bank's risk profiles.
The Board and Audit Committee must periodically evaluate the internal audit function to ensure its reliability and objectivity. This evaluation involves reviewing variations in risk profiles to see if the audit department is accurately identifying and assessing risks. Such

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oversight is necessary to maintain the quality of the audit process and confirm that it provides valuable assurance to institutional leadership.

58. (A) Cell F; Very High Risk
The credit card processing department has medium inherent risk and high control risk, which places it in Cell F. According to the standard risk matrix, this combination results in an overall assessment of very high risk. This highlights how a failure in control systems can significantly elevate the total risk level of even a moderately risky business activity within a bank.

59. (C) Yes, banks may consider transaction testing with an element of surprise in respect of low risk areas audited at longer intervals.
Under Risk-Based Internal Audit guidelines, banks may perform surprise transaction tests in low-risk areas that are otherwise audited at longer intervals. This practice helps ensure that controls remain effective during the gaps between routine audits. Adding an element of surprise discourages complacency and provides the bank with a more accurate picture of the ongoing control environment in those areas.

60. (B) Because these areas have longer audit intervals, surprise testing ensures continuous control maintenance.
Surprise transaction testing in low-risk areas is justified by their longer audit intervals. Because these areas are reviewed less frequently, surprise tests help maintain continuous control and ensure that standards are not slipping. This proactive approach ensures that even low-risk units remain compliant and that the overall internal control environment of the bank is consistently monitored and upheld by management.

61. (C) Cell E: Medium Inherent Risk, High Control Risk → High Risk
The risk matrix pairs coordinates with specific risk ratings. While Cell D is medium risk, Cell G is low risk, and Cell I is high risk, the pairing for Cell E is distinct. Cell E represents medium inherent risk and medium control risk, which is classified as high risk. A combination of medium inherent risk and high control risk actually indicates a very high risk.

62. (A) The internal audit head should normally report to the Board of Directors/Audit Committee of the Board.
To maintain functional independence, the head of internal audit should report directly to the Board of Directors or the Audit Committee. This reporting line ensures that the audit function is not under the influence of the managers whose operations it reviews. It provides auditors with the necessary authority and independence to report findings objectively and without fear of administrative retaliation.

63. (A) P-4, Q-3, R-1, S-2
Key audit concepts have specific definitions. Risk Based Internal Audit links risk management to control assurance. The Risk Matrix is a tool for presenting risk status. Inherent risk exists without mitigation plans, while control risk is the potential failure of existing procedures. These definitions form the foundation of a modern, risk-centric approach to internal auditing within global financial institutions.

64. (A) (I), (II), and (III) only
Internal auditing involves a systematic approach to provide objective assurance and consulting. Its goal is to help an organization achieve its objectives by evaluating risk and governance. However, auditors must not directly operate risk management or governance systems. Maintaining a clear separation between auditing and operating these systems is essential for preserving the independence and objectivity required for the audit function.

65. (B) No, the board and senior management are responsible for maintaining an effective system of internal control.
Corporate governance principles dictate that the Board of Directors and senior management are responsible for the system of internal control. They cannot transfer this responsibility entirely to the internal audit department. The audit function's role is to evaluate and provide assurance on the effectiveness of those controls, not to be the sole owner or operator of the internal control environment.

66. (B) (I) and (III) only
Functional independence requires that the internal audit department remains separate

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with a cash-settled financial instrument
(D) Ensuring that all derivative contracts are traded exclusively on unregulated markets

May/June 2017

19. A trader notices that the relationship between the value of a futures contract and the value of its underlying asset has been temporarily violated. The trader immediately executes simultaneous offsetting trades in both markets to secure a risk-free non-zero profit with no net investment. What strategy has the trader executed?
(A) Speculation
(B) Hedging
(C) Margin bonding
(D) Arbitrage

Oct/Nov 2010

20. Consider the following reasons why buyers and sellers might transact directly with dealers rather than on an exchange:
I It can be easier to trade a large quantity directly with another party.
II It avoids exchange fees and uncertainty about price resulting from announcing large sales.
III It allows trading a customized financial claim not available on an exchange.
IV It allows executing an entire trade of different financial claims as a single transaction.
V It guarantees absolute elimination of default risk through statutory regulatory backing.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (IV)
(B) (I), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (IV), and (V)

May/June 2009

21. What is the process wherein a clearinghouse determines an average of the final futures trades of the day and designates that price to reflect the passage of time and new information?
(A) Novation
(B) Notional principal calculation
(C) Mark to market or daily settlement
(D) Expiration date exercise

Oct/Nov 2022

22. Which of the following statements incorrectly classifies the general classes of derivatives?
(A) Forward commitments force the two parties to transact in the future at a previously agreed-on price
(B) Forward contracts, futures contracts, and swaps are primary examples of contingent claims
(C) Contingent claims provide the right but not the obligation to buy or sell the underlying at a pre-determined price
(D) The primary contingent claim is called an option

May/June 2025

23. Consider the following characteristics of exchange-traded derivatives:
I Standardization of contract terms facilitates a more liquid market.
II Clearing refers to the process of transferring money between participants.
III The clearinghouse requires a margin bond or performance bond to provide a credit guarantee.
IV Transparency means that full information on transactions is disclosed to exchanges and regulatory bodies.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), (III), and (IV)

Oct/Nov 2016

24. How is a forward contract defined?
(A) A standardized derivative contract traded on an exchange with daily settlement of gains
(B) A contingent claim giving the purchaser the right to buy a specified quantity of a commodity
(C) An agreement to exchange a series of cash flows determined by a variable series
(D) An over-the-counter agreement to buy an asset at a later date at a fixed price

May/June 2020

25. Match the uses of derivatives in List I with their accurate descriptions in List II.
List I: (Uses of Derivatives)

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CHAPTER 34
Derivatives and Risk Management

May/June 2021

1. Match the derivative terminology in List I with its accurate description in List II.
List I: (Derivative Terminology)
P. Long Position
Q. Short Position
R. Novation
S. Leverage
List II: (Description)
1. Investing only a small amount of capital relative to the value of the underlying
2. Substitution of one counterparty for another by a derivatives clearinghouse
3. Held by the buyer who owns the derivative
4. Held by the seller or the writer of the derivative

(A) P-1, Q-2, R-3, S-4
(B) P-4, Q-3, R-1, S-2
(C) P-2, Q-1, R-4, S-3
(D) P-3, Q-4, R-2, S-1

Oct/Nov 2014

2. A mutual fund manager wishes to sell large quantities of stocks and buy bonds. Instead of undertaking these trades directly in the spot market and paying heavy brokerage fees and bid-ask spreads, the manager uses derivatives to achieve the exact same economic effect. Which specific benefit of derivatives is driving this decision?
(A) Legalized gambling
(B) Arbitrage exploitation
(C) Reduced transaction costs
(D) Enhanced systemic contagion

May/June 2018

3. A farmer enters into an agreement with a bread manufacturer to sell wheat four months later at ₹ 2000 per ton. If the market price of wheat drops to ₹ 1800 per ton after four months, which of the following represents the financial outcome of this derivative contract?
(A) The buyer gains as he can purchase wheat at the lower market price
(B) Both parties lose because the underlying asset's value has significantly depreciated
(C) The farmer gains by selling wheat at the higher ₹ 2000 agreed price
(D) The contract becomes void due to the negative price movement of the asset

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Oct/Nov 2005

4. Two corporate counterparties enter into a short-term, non-negotiable forward agreement. At the expiration date, instead of delivering the underlying asset, they settle the contract by simply exchanging cash based on the price difference. What type of contract have they executed?
(A) An exchange-traded futures contract
(B) An American-style put option
(C) A non-deliverable forward (NDF)
(D) An interest rate swap

May/June 2012

5. The following question consists of two statements—Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): Derivatives exchanges use their clearinghouses to provide a credit guarantee to the winning party of a contract.
Reason (R): The clearinghouse is able to provide this guarantee by requiring a cash deposit, usually called the margin bond, from the participants.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

from the control processes it evaluates. The Chief Risk Officer and Chief Compliance Officer help support this independence. Crucially, the Chief Audit Officer must not take responsibility for operating internal control systems, as doing so would compromise their ability to provide an objective and unbiased assessment of those systems.

67. (D) Objectivity
Objectivity is a psychological state where auditors must remain impartial and free from conflicts of interest. By intentionally ignoring evidence to protect colleagues, an auditor fundamentally breaches this principle. This bias undermines the entire audit process, as resulting findings are not based on a fair or factual assessment. Objectivity is essential for the credibility and effectiveness of the internal audit function.

68. (A) An area falling in Cell G (Low Inherent Risk, Low Control Risk) mandates immediate 100% transaction testing.
The risk matrix is used to plan audits, with higher-risk areas receiving more frequent and intensive reviews. While high-risk cells may have shorter intervals, a low-risk cell like G does not mandate immediate 100% transaction testing. Instead, low-risk areas are typically audited at longer intervals and are subject to less intensive testing unless specific concerns or surprise elements are required.

69. (B) By transaction type
Auditing a specific business activity across multiple global locations represents an approach to identifying audit units by transaction type. This method focuses on the risks inherent in the specific operation, such as letters of credit, rather than the geographic location or broader department functions. It allows for a specialized and consistent review of a particular transaction across the entire organization.

70. (B) Cell A; High Risk
The new derivative trading desk has high inherent risk due to its volatile nature. However, because management has implemented effective AI-driven monitoring routines, the control risk is low. According to the risk matrix, this combination of high inherent risk and low control risk places the unit in Cell A, resulting in an overall risk rating of high risk for the desk.

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Oct/Nov 2009

12. In a derivative transaction, what is the term used for the buyer who purchases the derivative?
(A) The short or the writer
(B) The clearinghouse or the dealer
(C) The long or the holder
(D) The novation or the intermediary

May/June 2019

13. An investor carefully analyzes macroeconomic trends and anticipates an upcoming credit event. They enter into a derivative contract based solely on the expected future value of the underlying assets, fully willing to bear the inherent risk to make a profit. Which activity is the investor primarily engaged in?
(A) Speculation
(B) Hedging
(C) Arbitrage
(D) Novation

Oct/Nov 2018

14. Consider the following statements regarding the trade-offs associated with exchange markets:
I Transparency means a loss of privacy as national regulators can see what transactions have been done.
II Standardization means a loss of flexibility as a participant can do only the transactions permitted on the exchange.
III Regulation directly eliminates the need for any margin bonds or performance guarantees.
Which of the above statement(s) is/are correct?
(A) (I) and (II)
(B) (II) and (III)
(C) (I) and (III)
(D) (I), (II), and (III)

May/June 2005

15. Match the major types of derivatives in List I with their key characteristics in List II.
List I: (Types of Derivatives)
P. Forward Contract
Q. Futures Contract
R. Option Contract
S. Swap Contract
List II: (Characteristics)
1. Provides the right to either buy or sell an underlying asset at a fixed price prior to or on expiration
2. Standardized, exchange-traded, features daily settling of gains and losses
3. Over-the-counter agreement to exchange a series of cash flows over a stated period
4. Over-the-counter commitment to purchase an underlying asset at a later date at a fixed price
(A) P-2, Q-4, R-1, S-3
(B) P-1, Q-3, R-2, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-4, Q-2, R-1, S-3

Oct/Nov 2025

16. Which of the following accurately describes the concept of risk transfer in derivative instruments?
(A) Derivatives facilitate the transfer of existing risks from one party to another
(B) Derivatives eliminate the inherent underlying risk completely from the financial system
(C) The values of underlying assets change inherently when a derivative is initiated
(D) Derivatives transfer risk by legally converting financial assets into physical commodities

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May/June 2014

17. Regarding the initiation of a forward contract, which of the following concepts is accurate?
(A) No money changes hands between parties when the contract is initiated
(B) A substantial margin deposit must be transferred to a clearinghouse immediately
(C) The buyer must pay a premium to the seller to secure the right to purchase the asset
(D) Both parties must exchange the underlying physical assets at the start

Oct/Nov 2006

18. What is the primary purpose of novation performed by a derivatives clearinghouse?
(A) Managing credit risk by acting as a universal counterparty to all market participants
(B) Eliminating the bid-ask spread in over-the-counter transactions between private buyers
(C) Replacing the underlying physical asset

Oct/Nov 2019

6. Consider the following statements regarding the characteristics of a futures contract:

I It is a customized contract negotiated privately over the counter.

II It is created and traded on a futures exchange.

III It features a daily settling of gains and losses known as mark to market.

IV Either party has the right to transfer the contract obligation to a third party before expiry.

Which of the above statement(s) is/are correct?

(A) (I), (II), and (III)
(B) (II), (III), and (IV)
(C) (I), (III), and (IV)
(D) (I), (II), (III), and (IV)

May/June 2007

7. Which of the following most accurately defines a derivative?

(A) An original asset that holds intrinsic physical value in the spot market
(B) Something derived from a source rather than being an original asset
(C) A standardized contract restricted solely to physical commodity exchange
(D) A non-negotiable legal agreement involving immediate cash settlement

Oct/Nov 2024

8. A corporate treasurer enters into a derivative transaction to ensure that a potential fall in the value of the corporation's assets will be exactly offset by an increase in the value of the derivative contract. What specific risk management process is being utilized?

(A) Arbitrage
(B) Hedging
(C) Speculation
(D) Margin trading

May/June 2015

9. The following question consists of two statements—Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.

Assertion (A): Speculation through derivatives often has destabilizing consequences and can bring instability to the market.

Reason (R): Speculators use large amounts of leverage, subjecting themselves and their creditors to substantial risk, whereby defaults can lead to systemic contagion.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2011

10. Consider the following statements regarding the features of derivatives:

I Derivatives generally trade at lower transaction costs than comparable spot market transactions.

II Derivatives are characterized by a relatively low degree of leverage, requiring high initial capital relative to the underlying.

Which of the above statement(s) is/are correct?

(A) Both (I) and (II) are correct
(B) Both (I) and (II) are incorrect
(C) Only (I) is correct
(D) Only (II) is correct

May/June 2023

11. On June 1, an individual expects to receive ₹ 10 cr on October 1, which he intends to invest in government bonds. Fearing that interest rates will fall and bond prices will rise, he enters into a government bond futures contract on June 1 to buy bonds on October 1. What does this strategy achieve?

(A) Obtaining the right to abandon the purchase if market prices fall below expectation
(B) Eliminating credit risk by bypassing the exchange and trading directly with the issuer
(C) Transferring the physical government bonds into his account on the contract initiation date
(D) Locking in a specific interest rate for a bond purchase on a future date

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P. Hedging
Q. Speculation
R. Reduced transaction costs
S. Arbitrage

List II: (Descriptions)

1. Attempting to profit from anticipating changes in market prices or credit events
2. Locking in a riskless profit by exploiting mispricing simultaneously in two or more markets
3. Protecting against risks such that a fall in asset value is compensated by the derivative
4. Achieving the same economic effect as trading underlying assets but avoiding bid-ask spreads and broker fees

(A) P-1, Q-3, R-2, S-4
(B) P-3, Q-1, R-4, S-2
(C) P-4, Q-2, R-1, S-3
(D) P-2, Q-4, R-3, S-1

Oct/Nov 2007

26. Which of the following statements correctly identifies the nature of underlying entities in derivative contracts?

(A) The underlying must always be a physical commodity such as wheat or gas
(B) The underlying is restricted exclusively to financial securities like equities and bonds
(C) The underlying must be an original asset that is deliverable upon contract initiation
(D) Underlyings can include assets like interest rates, credit, energy, and weather

May/June 2013

27. A bakery enters into a forward contract with a sugar manufacturer on June 1 to buy sugar on October 31. According to the mechanics of forward contracts, what is the immediate financial obligation between the bakery and the manufacturer on June 1?

(A) No cash exchange occurs, but the contract is legally binding on both parties
(B) The bakery must immediately pay the full forward price to the manufacturer
(C) The manufacturer must immediately deliver the physical sugar to the bakery
(D) The bakery must pay a non-refundable premium to the manufacturer

Oct/Nov 2021

28. Which of the following is NOT an attribute of an exchange-traded derivative?

(A) Highly customized and flexible contract terms
(B) Creation of a clearing and settlement operation
(C) Full information on all transactions is disclosed to regulatory bodies
(D) Provision of a credit guarantee through a clearinghouse

May/June 2024

29. Which of the following is NOT cited as a major criticism or misuse of derivatives?

(A) They permit legalized gambling by attracting speculators who willingly accept risk
(B) Speculation through derivatives can lead to systemic defaults and an epidemic contagion
(C) They fundamentally eliminate the ability of market participants to utilize leverage
(D) They are exceptionally complex and require a high-level understanding of mathematics

Oct/Nov 2008

30. What is the primary economic function of a dealer in an over-the-counter (OTC) trade?

(A) To impose strict standardization on customized contracts within the private market
(B) To mandate maximum transparency and report all trades instantly to national regulators
(C) To prohibit the execution of multiple financial claims as a single transaction
(D) To serve as a counterparty and facilitate liquidity for a large investor base

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May/June 2006

31. Consider the following statements regarding swap contracts:

I A swap is typically an over-the-counter contract, privately negotiated between counterparties.
II Because swaps involve a series of periodic payments, they are completely immune to counterparty default risk.

Which of the following is correct?

(A) Both (I) and (II) are correct

market price may fall over the upcoming months. To protect himself, he borrows contracts to sell futures at current high prices, intending to repurchase them at a lower price later. What specific strategy is he executing to protect against the price fall?
(A) Short Position: Sell High Buy Low
(B) Long Position: Buy Low Sell High
(C) Arbitrage pricing
(D) Interest rate swap hedging

May/June 2014

59. A scheduled commercial bank wishes to mitigate the risk of default on a large corporate loan it has issued. Based on regulatory guidelines provided by the Reserve Bank of India (RBI), which specific OTC derivative instrument can the bank enter into?
(A) Interest rate futures on 10-year bonds
(B) Index futures contract
(C) Single-entity credit default swap
(D) Non-deliverable currency forward

Oct/Nov 2006

60. Match the Committees in List I with their corresponding roles in developing the Indian derivatives market in List II.
List I: (Committees)
P. L. C. Gupta Committee
Q. J. R. Verma Committee
List II: (Roles)
1. Recommended that derivatives trading be allowed in a phased manner
2. Worked out operational details such as the margining system
(A) P-1, Q-1
(B) P-1, Q-2
(C) P-2, Q-2
(D) P-2, Q-1

May/June 2017

61. Which of the following statements most accurately describes exchange-traded derivatives relative to over-the-counter derivatives?
(A) Exchange-traded derivatives are more likely to have greater credit risk
(B) Exchange-traded derivatives are illiquid in nature
(C) Exchange-traded derivatives are more likely to have standardized contract terms
(D) Exchange-traded derivatives are exclusively traded without any centralized clearinghouse

Oct/Nov 2010

62. Which of the following exchanges was NOT established around 2003 specifically to introduce commodity derivatives in India?
(A) Bombay Stock Exchange (BSE)
(B) Multi Commodity Exchange of India (MCX)
(C) National Multi Commodity Exchange (NMCE)
(D) National Commodity & Derivatives Exchange Limited (NCDEX)

May/June 2009

63. An institutional investor expects the value of a specific equity to decrease over the next few weeks. They decide to borrow shares of the equity from an investment company and sell them to another investor at the current high price. Their primary intent is to buy the stock back later at a lower price to return it. Which financial position is the investor initiating?
(A) A standardized long position
(B) A fully collateralized swap position
(C) A short position
(D) A cash-settled contingent position

Oct/Nov 2022

64. Which of the following is considered a primary challenge with over-the-counter (OTC) contracts?
(A) The inability to execute large quantity trades without alerting the exchange
(B) The mandatory requirement to post a margin bond with a central clearinghouse
(C) Searching for a party willing to enter into the contracts
(D) The high degree of strict standardization forcing a loss of privacy

May/June 2025

65. Match the following acronyms related to derivatives in List I with their correct expansions in List II.
List I: (Acronyms)
P. NDF
Q. FIA
R. NMCE
S. NCDEX
List II: (Expansions)

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correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2016

39. Match the key terms in List I with their formal definitions in List II.
List I: (Terms)
P. Hedge
Q. Speculation
R. Arbitrageur
S. Novation
List II: (Definitions)
1. An investor who tries to profit from price inefficiencies in a market by making two simultaneous offsetting trades
2. Buying and selling of assets with expectations of making a profit from the change in the price
3. The replacement of one of the parties in an agreement between two parties, with the agreement of all three
4. An investment made with the intention of reducing the risk of adverse price movements in an asset

(A) P-1, Q-3, R-4, S-2
(B) P-2, Q-4, R-3, S-1
(C) P-3, Q-1, R-2, S-4
(D) P-4, Q-2, R-1, S-3

Oct/Nov 2012

40. An investor conducts thorough fundamental research on Infosys and decides to buy 1000 shares at a closing price of ₹ 1700 per share, totaling ₹ 17,00,000. A year later, the stock price rises to ₹ 1750, resulting in a gain of ₹ 50,000. What specific market stance and strategy does this scenario illustrate?
(A) Short Position: Sell High Buy Low
(B) Arbitrage: Riskless Profit Exploitation
(C) Swap agreement execution
(D) Long Position: Buy Low Sell High

May/June 2010

41. Consider the following features regarding a short position:
I It follows the strategy of "Sell High Buy Low".
II The investor profits when the value of the asset falls.
III The investor initially buys the asset at a low price and waits for it to increase.
Which of the above statement(s) is/are correct?
(A) (I) and (II)
(B) (II) and (III)
(C) (I) and (III)
(D) (I), (II), and (III)

NODIA

Oct/Nov 2015

42. What defines a swap derivative contract?
(A) An agreement to lock in a single commodity delivery at a specified future price
(B) An exchange-traded mechanism requiring daily cash settlement of variable margins
(C) An over-the-counter contract to exchange a series of cash flows over a period
(D) A unilateral right allowing a buyer to force a seller to purchase equity shares

May/June 2021

43. Consider the following statements regarding the trajectory of interest rate futures on the NSE:
I NSE launched short-term and long-term interest rate futures in June 2003 based on a zero-coupon yield curve.
II NSE suspended the interest rate futures contracts in 2006.
III New long-term interest rate futures on 10-year government bonds were introduced in 2009.
IV The futures introduced in 2009 are cash-settled without physical delivery of the bonds.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV)
(B) (II), (III), and (IV)
(C) (I), (II), and (III)
(D) (I), (III), and (IV)

Oct/Nov 2014

44. Arrange the following key events in the history of the Indian derivative market in the correct chronological sequence:
1. The Indian economy was liberalized.
2. The government banned cash settlement and options trading.
3. The Bombay Cotton Trade Association started trading commodity futures.
4. The NSE was started in collaboration with

state financial institutions.
(A) 3, 2, 1, 4
(B) 2, 3, 1, 4
(C) 3, 1, 2, 4
(D) 1, 2, 3, 4

May/June 2018

45. Consider the following statements contrasting over-the-counter (OTC) derivatives with exchange-traded derivatives:
I Exchange-traded derivatives are standardized.
II OTC derivatives are highly regulated, transparent, and guarantee zero default risk.
III Exchange transactions are guaranteed against default through the clearinghouse.
IV OTC derivatives are flexible and more private.
V OTC derivatives are subject to a greater risk of default.
Which of the above statement(s) is/are correct?
(A) (I), (III), (IV), and (V)
(B) (I), (II), (IV), and (V)
(C) (I), (II), (III), and (V)
(D) (II), (III), (IV), and (V)

Oct/Nov 2005

46. Match the option terminology in List I with its accurate definition in List II.
List I: (Option Terminology)
P. Call option
Q. Put option
R. American-style option
S. European-style option
List II: (Definitions)
1. Can only be exercised on the expiration date
2. Gives the buyer the right to sell a specified quantity of an asset
3. Gives the purchaser the right to buy a specified quantity of an asset
4. Can be exercised on or before a certain future date
(A) P-2, Q-3, R-1, S-4
(B) P-3, Q-2, R-4, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-1, Q-4, R-2, S-3

May/June 2012

47. Which of the following is NOT typically considered an underlying entity for a derivative contract?
(A) Equities and fixed-income securities
(B) Real estate property deeds
(C) Energy and weather
(D) Credit and interest rates

Oct/Nov 2019

48. In a swap agreement, the periodic cash flow payments are mathematically calculated based on an agreed-upon foundational value. What is this value technically called?
(A) The mark-to-market settlement price
(B) The notional principal amount
(C) The option premium
(D) The intrinsic forward rate

May/June 2007

49. On what exact date did the Reserve Bank of India (RBI) allow banks to enter into single-entity credit default swaps?
(A) July 7, 1999
(B) June 1, 2000
(C) May 17, 2007
(D) October 31, 2008

Oct/Nov 2024

50. In which year was the Securities Contracts (Regulation) Act of 1956 amended to legally declare derivatives contracts as "securities" and enable them to be traded on stock exchanges?
(A) 1990
(B) 1995
(C) 1999
(D) 2003

May/June 2015

51. Consider the following statements regarding the fundamentals of derivatives:
I The risk itself does not change, but derivatives help to transfer these risks from one party to another.
II A ton of wheat is a primary example of a derivative because its value is determined in the corn market.
Which of the following is correct?
(A) Both (I) and (II) are correct
(B) Both (I) and (II) are incorrect
(C) Only (I) is correct
(D) Only (II) is correct

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Oct/Nov 2011

52. Fairweather Ltd, a Canadian company, wants to invest in India using Indian rupees. Progressive Co. plans to invest in Canada requiring Canadian dollars. Both firms find it convenient to borrow money in their own domestic currencies and then agree to exchange their respective loan cash flows. Which derivative are they primarily utilizing?
(A) Exchange-traded currency option
(B) Non-deliverable forward
(C) Interest rate futures
(D) Currency swap

May/June 2023

53. Which of the following statements correctly differentiates long and short positions in the context of options?
(A) Buying a put or call option on an underlying asset within a standardized exchange
(B) Holding an option that gives the investor a mandatory obligation to buy or sell
(C) Selling an option where the writer must buy or sell if the holder exercises
(D) Entering long positions which carry significantly more risk than selling an option contract

Oct/Nov 2009

54. A non-resident financial institution seeks to trade forward rate agreements directly with an Indian dealer in the OTC market. Based on current regulatory frameworks, is this transaction theoretically permitted?
(A) No, these agreements are strictly prohibited for non-residents
(B) No, such trading can only occur on standardized derivative exchanges, not via OTC
(C) Yes, the scope of OTC trading includes non-resident Indians and non-resident financial institutions
(D) Yes, but only if they agree to settle the transactions physically in cash rather than electronically

May/June 2019

55. The following question consists of two statements—Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): The initial short-term and long-term interest rate futures launched by NSE in June 2003 experienced very thin trading volume.
Reason (R): There was an existence of well-developed OTC markets for interest rate swaps and forward rate agreements that diverted trading interest.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2018

56. Which of the following pairs incorrectly identifies the obligations or rights of the parties in an options transaction?
(A) Option purchaser - Always obligated to buy or sell the underlying asset under all circumstances
(B) Option buyer - Has the right, but not the obligation, to exercise the contract
(C) Option writer - Liable for covering costs of changes in the underlying's value if exercised
(D) Option seller - Receives a sum of money known as the option premium

May/June 2005

57. Which of the following pairs incorrectly matches a derivative concept with its corresponding mechanism?
(A) Short position holder - Owns the security or asset and profits if the value rises
(B) Underlying asset trades - Cash or spot markets
(C) Over-the-counter derivatives - Customized, flexible, and more private
(D) Exchange-traded derivatives - Guaranteed against default through a clearinghouse

Oct/Nov 2025

58. A manufacturer holds a massive physical inventory of aluminum and fears that the

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18. (A) Managing credit risk by acting as a universal counterparty to all market participants
Novation is the process by which a clearinghouse interposes itself between the buyer and the seller of a contract. By becoming the buyer to every seller and the seller to every buyer, the clearinghouse centralizes and manages credit risk. This ensures that the failure of one participant does not directly impact their original counterparty, thereby maintaining overall market stability.

19. (D) Arbitrage
Arbitrage is a trading strategy that exploits price discrepancies between two or more markets to earn a risk-free profit. By simultaneously buying an asset in a lower-priced market and selling it in a higher-priced market, the trader secures a gain without any net investment. This activity helps maintain market efficiency by quickly aligning prices across different financial venues.

20. (A) (I), (II), (III), and (IV)
Over-the-counter trading allows participants to execute large transactions directly with dealers to avoid exchange fees and the potential price impact of public announcements. These private markets offer high flexibility, enabling the creation of customized financial claims and the execution of multiple trades as a single transaction. However, unlike exchanges, OTC markets do not provide a statutory guarantee against default risk.

21. (C) Mark to market or daily settlement
Mark to market is a daily settlement process where the clearinghouse calculates the gains and losses of every participant based on the day's closing price. This mechanism ensures that profits are credited and losses are debited to accounts each day, preventing the accumulation of large unpaid debts. It reflects the impact of new information and the passage of time.

22. (B) Forward contracts, futures contracts, and swaps are primary examples of contingent claims
Forward commitments, such as forward contracts, futures, and swaps, obligate both parties to fulfill the transaction at the agreed-on price. In contrast, contingent claims, primarily options, provide the holder the right but not the obligation to buy or sell the underlying asset. Therefore, classifying forwards and swaps as contingent claims is incorrect as they represent mandatory future contractual obligations.

NODIA

23. (B) (I), (III), and (IV)
Exchange-traded derivatives utilize standardization to create liquid markets and require margin bonds to provide credit guarantees via a clearinghouse. Transparency is maintained as all transaction data is disclosed to regulators and the exchange itself. While clearing involves the management of positions, it is specifically the margin and novation processes that provide the safety and guarantee for these trades.

24. (D) An over-the-counter agreement to buy an asset at a later date at a fixed price
A forward contract is a private, non-standardized agreement between two parties to purchase or sell an underlying asset at a specified future time for a price agreed upon today. These contracts are traded in the over-the-counter market and are highly customizable to meet the specific needs of the counterparties regarding the delivery date, quantity, and quality of the asset.

25. (B) P-3, Q-1, R-4, S-2
Hedging involves protecting against losses in asset value, while speculation is the attempt to profit from market price changes. Arbitrage seeks riskless profits by exploiting price differences in different markets. Using derivatives also helps in reducing transaction costs by achieving economic results without the heavy fees and spreads associated with physical asset trades in the spot market.

26. (D) Underlyings can include assets like interest rates, credit, energy, and weather
The underlying of a derivative contract is the source from which the instrument derives its value and can encompass a wide variety of entities. These include traditional financial assets like stocks and bonds, but also non-traditional sources such as interest rates, credit events, energy prices, and even weather conditions. This diversity allows for complex risk management across many economic sectors.

1. National Commodity & Derivatives Exchange Limited
2. Futures Industry Association
3. Non-deliverable forwards
4. National Multi Commodity Exchange

(A) P-1, Q-4, R-2, S-3
(B) P-3, Q-2, R-4, S-1
(C) P-4, Q-1, R-3, S-2
(D) P-2, Q-3, R-1, S-4

Oct/Nov 2016

66. Which of the following statements correctly identifies the historical system known as "badla"?

(A) A highly regulated options trading mechanism cleared by the national stock exchange
(B) An informal market established specifically to trade single-entity credit default swaps
(C) The first fully automated screen-based trading system introduced by the regulator
(D) A form of forward trading in equities that was eventually banned from the market

May/June 2020

67. Consider the following statements regarding the mechanics and expectations of a long position:

I Purchasing assets in a long position expects the value of the asset will increase over time.
II It relies on the strategy to buy stocks at a low price and sell them at a high price.
III A long position holder has unlimited profit potential.
IV The investor borrows the shares from an investment company to sell to another investor.
V A person is considered to have a long position when he owns the security or asset.

Which of the above statement(s) is/are correct?

(A) (I), (II), (III), and (V)
(B) (I), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (III), and (IV)

Oct/Nov 2007

68. Identify the incorrect statement regarding the trading of OTC derivatives as permitted by regulatory authorities in India.

(A) These OTC trades were originally allowed only for non-resident foreign institutional investors
(B) Interest rate swaps and forward rate agreements were allowed on July 7, 1999
(C) Currency swaps were allowed on July 7, 1999
(D) Banks were allowed to enter into single-entity credit default swaps on May 17, 2007

May/June 2013

69. Arrange the rollout of currency futures contracts on Indian exchanges in chronological order:

1. Futures introduced on Japanese yen, British pound, and euro.
2. Currency futures introduced in the BSE and NSE for the U.S.-dollar-to-rupee.
3. Currency futures introduced in the Multi Commodity Exchange.

(A) 2, 3, 1
(B) 1, 2, 3
(C) 3, 2, 1
(D) 2, 1, 3

Oct/Nov 2021

70. Identify the incorrect statement regarding the global standing and performance of Indian derivative exchanges.

(A) Growth in derivatives trading in India has been phenomenal
(B) Statistics validating NSE's rank were maintained exclusively by the Securities and Exchange Board of India (SEBI)
(C) Indian exchanges have excelled on a global level
(D) The National Stock Exchange was the world's largest derivatives exchange for the third consecutive year in 2021

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ANSWERS

1. (D) P-3, Q-4, R-2, S-1
A long position is held by the buyer or holder of a derivative, while a short position is held by the seller or writer. Novation is the process where a clearinghouse replaces the original counterparty to ensure transaction security. Leverage allows investors to control large asset values using only a relatively small amount of initial capital.

2. (C) Reduced transaction costs
Mutual fund managers use derivatives to replicate the economic impact of buying or selling assets without incurring the high expenses of physical trading. This strategy significantly lowers brokerage fees and avoids wide bid-ask spreads typically found in spot markets. Consequently, derivatives provide a more cost-effective method for institutional investors to manage large portfolios and adjust asset allocations.

3. (C) The farmer gains by selling wheat at the higher ₹ 2000 agreed price
In a forward contract, the seller is obligated to deliver the asset at the pre-determined price regardless of market fluctuations. If the market price drops below the contracted price at expiration, the seller benefits by receiving a higher value than currently available. This mechanism allows producers to lock in profits and protect themselves against downward price volatility.

4. (C) A non-deliverable forward (NDF)
A non-deliverable forward is a specialized cash-settled short-term forward contract typically traded in the over-the-counter market. Instead of physical delivery of the underlying asset, the counterparties settle the agreement by exchanging the difference between the contracted price and the prevailing spot price. These instruments are commonly used for hedging in markets where physical settlement is restricted.

5. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Clearinghouses provide a credit guarantee to market participants by acting as the counterparty to every trade through the process of novation. To back this guarantee, the exchange requires all participants to maintain a cash deposit known as a margin bond. This collateral ensures that the winning party receives their profit even if the losing party defaults.

6. (B) (II), (III), and (IV)
Futures contracts are standardized instruments traded on regulated exchanges rather than being customized over-the-counter agreements. They feature a daily mark-to-market process where gains and losses are settled continuously to reflect current market prices. Additionally, participants have the flexibility to transfer their contractual obligations to third parties by taking an offsetting position in the market before expiry.

7. (B) Something derived from a source rather than being an original asset
A derivative is a financial instrument that lacks intrinsic value of its own but derives its worth from an underlying source. This underlying source can be a physical commodity, a financial security, an interest rate, or even an index. These contracts allow participants to trade the price movements of the source without necessarily owning the physical asset itself.

8. (B) Hedging
Hedging is a risk management strategy used to protect an investment against adverse price movements. By entering into a derivative contract, an investor ensures that any loss in the value of their physical asset is compensated by a corresponding gain in the derivative. This process effectively neutralizes risk and provides financial stability against unpredictable market fluctuations and volatility.

NODIA

9. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Speculators use high levels of leverage to gain significant market exposure with minimal capital, which can lead to systemic instability if large-scale defaults occur. Their activities involve taking substantial risks based on price expectations, which can amplify market movements. When these leveraged positions fail, the resulting defaults can trigger a contagion effect throughout the entire financial network.

10. (C) Only (I) is correct
Derivatives are primarily used because they offer significantly lower transaction costs compared to similar trades in the spot market. Furthermore, they are characterized by high leverage, meaning they require a very small amount of initial capital relative to the total value of the underlying. This combination makes them attractive for both hedgers looking for protection and speculators seeking profit.

11. (D) Locking in a specific interest rate for a bond purchase on a future date
By entering into a bond futures contract, an investor can fix the purchase price of government bonds ahead of time. This strategy effectively locks in the current interest rate, protecting the investor from potential rate declines and subsequent increases in bond prices. It ensures that the future investment of funds remains predictable regardless of intervening market changes or volatility.

12. (C) The long or the holder
In the terminology of derivative markets, the party who buys the contract is referred to as holding a long position or being the holder. This individual typically expects the value of the underlying asset to increase over the contract's duration. Conversely, the seller is known as the short or the writer, who generally benefits if the asset value decreases.

13. (A) Speculation
Speculation involves making financial transactions with a high risk of loss in exchange for the possibility of significant profit. Investors engaged in this activity use their analysis of market trends and economic events to place bets on the future value of assets. Unlike hedgers, speculators willingly bear risk without holding an underlying position, providing essential liquidity to the market.

14. (A) (I) and (II)
Trading on a regulated exchange provides transparency but leads to a loss of privacy as transactions are visible to national regulators. Additionally, the standardization required for exchange trading results in a loss of flexibility because participants must adhere to fixed contract terms. While these features enhance safety and liquidity, they limit the customization available in private over-the-counter derivative markets.

15. (D) P-4, Q-2, R-1, S-3
Forward contracts are private OTC agreements to trade assets later at fixed prices, while futures are standardized and exchange-traded with daily settlement. Options provide the right but not the obligation to trade at a specific price. Swaps are over-the-counter contracts where parties exchange a series of periodic cash flows based on underlying variables like interest rates or currencies.

16. (A) Derivatives facilitate the transfer of existing risks from one party to another
Derivatives serve as a financial mechanism to redistribute existing risks within the economy rather than eliminating them entirely. They allow parties who wish to avoid specific risks, such as price volatility, to transfer those risks to counterparties willing to bear them for a potential profit. This transfer improves financial efficiency by placing risk with those best able to manage it.

17. (A) No money changes hands between parties when the contract is initiated
Unlike options which require an upfront premium, forward contracts are typically initiated without any immediate exchange of cash between the buyer and the seller. The agreement is a legally binding commitment to trade at a future date, and its value at inception is generally zero. Financial obligations only arise as the market price deviates from the agreed-upon forward price.

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(B) Both (I) and (II) are incorrect
(C) Only (I) is correct
(D) Only (II) is correct

Oct/Nov 2017

32. Identify the incorrect statement regarding the introduction of currency futures in India.
(A) Currency futures contracts were introduced in the BSE and NSE in August 2008
(B) The only available contract at that time in 2008 was the Japanese-yen-to-rupee contract
(C) They were introduced in the Multi Commodity Exchange in October 2008
(D) In 2010, futures were also introduced on the Japanese yen, British pound, and euro

May/June 2008

33. An investor purchases a standardized derivative contract giving them the right to buy a stock at a specified exercise price. At the expiration date, the market price of the stock is lower than the exercise price, making the transaction unprofitable. What is the maximum financial loss the purchaser incurs under these circumstances?
(A) The full notional principal amount of the contract
(B) Simply the option premium originally paid
(C) The difference between the exercise price and the spot price
(D) The daily mark-to-market margin payments

Oct/Nov 2013

34. What is the most appropriate primary purpose of a hedge?
(A) To guarantee that the financial outcome with hedging will categorically exceed the outcome without hedging
(B) To aggressively exploit market mispricing across two simultaneous offsetting trades
(C) To increase the intrinsic value of the underlying spot price
(D) To reduce the risk of adverse price movements in an asset

May/June 2011

35. Which association started trading commodity futures in India as early as 1875?
(A) The Bombay Cotton Trade Association
(B) The National Stock Exchange
(C) The Securities and Exchange Board of India
(D) The Multi Commodity Exchange of India

Oct/Nov 2020

36. The following question consists of two statements—Assertion (A) and Reason (R). Answer the question by selecting the appropriate option.
Assertion (A): A swap contract is structurally a bit more like a forward contract than a futures contract.
Reason (R): A swap is an over-the-counter (OTC) contract, privately negotiated and inherently subject to counterparty default risk.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

NODIA

May/June 2022

37. How is an option defined in the context of derivatives?
(A) A contract granting the right to buy or sell an asset at a fixed price
(B) A contract where two parties exchange a series of cash flows over a stated period
(C) A mandatory agreement to purchase an underlying asset with daily margin settlement
(D) An unalterable commitment to exchange physical commodities regardless of price changes

Oct/Nov 2023

38. Consider the following sequence of derivative products offered and traded on the BSE and NSE:
I Index futures were introduced in June 2000.
II Index options were introduced in June 2001.
III Options and futures on individual securities were introduced in July 2001 and November 2001, respectively.
Which of the above statement(s) is/are

27. (A) No cash exchange occurs, but the contract is legally binding on both parties
At the initiation of a standard forward contract, the agreement is established with zero initial value, meaning no cash is exchanged between the buyer and the seller. The contract becomes a legally binding commitment for both parties to perform their respective obligations at the future expiration date. Financial impact only occurs later as the market price changes relative to the fixed price.

28. (A) Highly customized and flexible contract terms
Exchange-traded derivatives are characterized by standardization of contract terms, which facilitates high liquidity and ease of trading among diverse participants. Unlike over-the-counter derivatives which offer customization and flexibility, exchange contracts have fixed sizes, expiration dates, and quality standards. Exchanges also provide centralized clearing, transparency to regulators, and credit guarantees through clearinghouses to ensure market integrity and reduce counterparty risk.

29. (C) They fundamentally eliminate the ability of market participants to utilize leverage
Derivatives are frequently criticized for their extreme complexity and for potentially enabling legalized gambling through high-risk speculation. Critics also point out that the misuse of these instruments can lead to systemic contagion and financial instability. However, derivatives are actually known for providing high leverage, which allows participants to control large positions with minimal capital, rather than eliminating it.

30. (D) To serve as a counterparty and facilitate liquidity for a large investor base
In the over-the-counter market, dealers play a crucial role by acting as ready counterparties to investors, thereby providing necessary liquidity. They facilitate large or customized trades that might be difficult to execute on a standardized exchange. By standing willing to buy or sell at quoted prices, dealers enable participants to manage their financial risks and positions more effectively and privately.

31. (C) Only (I) is correct
Swaps are over-the-counter contracts that are privately negotiated between two parties, allowing for a high degree of customization. However, because they are private agreements without a central clearinghouse guarantee, they are inherently subject to counterparty default risk. The periodic nature of the payments actually increases the potential for one party to fail to meet their financial obligations over time.

32. (B) The only available contract at that time in 2008 was the Japanese-yen-to-rupee contract
Currency futures were launched in India in August 2008 on the NSE and BSE, but the initial contracts were exclusively for the U.S.-dollar-to-rupee pair. It was not until 2010 that the market expanded to include other major currencies such as the Japanese yen, British pound, and euro. These instruments were introduced to provide a transparent platform for hedging currency risk.

33. (B) Simply the option premium originally paid
The purchaser of an option contract has the right, but not the obligation, to exercise the contract. If the market price moves unfavorably, making the exercise unprofitable, the holder can simply let the option expire worthless. In this scenario, the total financial loss is strictly limited to the initial premium paid to the seller at the start of the contract.

34. (D) To reduce the risk of adverse price movements in an asset
The fundamental purpose of hedging is to mitigate or eliminate the potential for financial loss caused by unfavorable changes in the price of an asset. By taking an offsetting position in a derivative contract, an investor ensures that a loss in the physical market is balanced by a gain in the derivative. It is a protective strategy, not a profit-maximization tool.

35. (A) The Bombay Cotton Trade Association
The Bombay Cotton Trade Association established one of the earliest organized commodity futures markets in India in 1875. This association facilitated the trading of cotton futures, allowing participants to hedge against price volatility in the cotton industry. This

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53. (C) Selling an option where the writer must buy or sell if the holder exercises
In an options contract, the seller or writer takes a short position and receives a premium for assuming the obligation to perform. If the holder decides to exercise their right to buy or sell the underlying asset, the writer must fulfill the transaction regardless of the current market price. This creates a mandatory obligation for the seller that is contingent upon the buyer's decision.

54. (C) Yes, the scope of OTC trading includes non-resident Indians and non-resident financial institutions
Regulatory frameworks in India permit a variety of participants, including non-resident financial institutions and non-resident Indians, to engage in over-the-counter derivative transactions such as forward rate agreements. These trades are conducted directly between parties or through dealers rather than on a centralized exchange. This inclusion helps integrate the Indian financial market with global participants while allowing for customized risk management solutions.

55. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The interest rate futures launched by the NSE in 2003 saw very low trading volumes because the market was already dominated by well-established over-the-counter products. Participants preferred the flexibility and liquidity of OTC interest rate swaps and forward rate agreements over the new exchange-traded contracts. This established competition made it difficult for the standardized futures to attract significant market share initially.

56. (A) Option purchaser - Always obligated to buy or sell the underlying asset under all circumstances
An option purchaser is characterized by having the right to buy or sell the underlying asset, but they are never under a mandatory obligation to do so. They pay a premium to the seller to obtain this choice, allowing them to let the contract expire if it is not profitable. The obligation to perform lies solely with the option writer or seller.

57. (A) Short position holder - Owns the security or asset and profits if the value rises
A short position holder does not own the underlying asset; instead, they sell a borrowed asset with the expectation that its price will decrease. They profit only when the market value falls, allowing them to repurchase the asset at a lower price. In contrast, it is the long position holder who owns the security and benefits from rising market prices.

58. (A) Short Position: Sell High Buy Low
A manufacturer protecting against a price fall in their inventory uses a short position strategy. By selling futures contracts at current higher prices, they lock in their revenue. If market prices decline as feared, they can fulfill their obligation or repurchase the contracts at a lower price, thereby offsetting the loss in the physical value of their aluminum with a derivative profit.

59. (C) Single-entity credit default swap
According to the Reserve Bank of India, banks can use single-entity credit default swaps to hedge against the risk of a specific borrower defaulting on a loan. In this over-the-counter transaction, the bank pays a periodic fee to a counterparty who agrees to compensate the bank if the credit event occurs. This instrument effectively transfers the credit risk from the bank's balance sheet.

NODIA

60. (B) P-1, Q-2
The L. C. Gupta Committee was instrumental in recommending that derivatives trading be introduced in India through a phased approach to ensure market stability. Following this, the J. R. Verma Committee focused on the operational and technical aspects, such as developing the margining system required for risk management. Together, these committees established the foundational regulatory and operational framework for the Indian derivatives market.

settlements to curb speculation. The market transformed again with economic liberalization in the 1990s, leading to the establishment of the National Stock Exchange in collaboration with state financial institutions to modernize the financial system.

45. (A) (I), (III), (IV), and (V)
Exchange-traded derivatives are standardized and benefit from clearinghouse guarantees against default, ensuring high liquidity and transparency. In contrast, over-the-counter derivatives are flexible and private but carry a greater risk of default because they rely on the creditworthiness of the counterparties. OTC contracts allow for customization but lack the centralized oversight and security mechanisms provided by regulated financial exchanges and clearinghouses.

46. (B) P-3, Q-2, R-4, S-1
A call option grants the purchaser the right to buy an asset, while a put option provides the right to sell it. American-style options are flexible and can be exercised at any time up to the expiration date. In contrast, European-style options are more restrictive and can only be exercised on the specific date the contract expires, affecting their valuation.

47. (B) Real estate property deeds
Underlying entities for derivative contracts typically include liquid financial assets like equities, bonds, and interest rates, or commodities like energy and agricultural products. Weather and credit events are also used as underlyings in specialized markets. However, individual real estate property deeds are not commonly used as underlyings for standardized derivatives because they are non-fungible and lack the necessary market liquidity.

48. (B) The notional principal amount
The notional principal is a theoretical foundational value used to calculate the periodic cash flows in a swap agreement. Although it determines the size of the interest or currency payments, the principal itself is typically not exchanged between the counterparties. This allows parties to gain exposure to the price movements of a large asset value without actually committing or transferring the full capital.

49. (C) May 17, 2007
On May 17, 2007, the Reserve Bank of India issued comprehensive guidelines for the management of over-the-counter derivatives by commercial banks and financial institutions. This regulatory move was intended to provide a framework for managing financial risks and enhancing the stability of the banking sector. It established clear standards for participants engaging in interest rate and currency derivative transactions in the OTC market.

50. (C) 1999
The Securities Contracts (Regulation) Act of 1956 was amended in 1999 to officially include derivatives within the legal definition of "securities." This landmark legislative change paved the way for the introduction of exchange-traded derivatives in India, providing a robust legal framework for their regulation and trading. It ensured that derivative contracts could be legally enforced and traded on recognized stock exchanges.

51. (C) Only (I) is correct
Derivatives are financial tools designed to transfer existing risks between parties rather than eliminating the total risk within the economy. For example, while wheat is a primary commodity with its own value in the spot market, a contract based on its future price is the derivative. Therefore, the risk is redistributed to those willing to bear it in exchange for a potential profit.

52. (D) Currency swap
A currency swap involves two parties exchanging principal and interest payments in different currencies to obtain better borrowing terms in their respective domestic markets. In this scenario, the Canadian and Indian firms use the swap to fulfill their investment needs in foreign currencies while leveraging their domestic credit advantages. This derivative facilitates international investment by reducing the costs associated with foreign currency borrowing.

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introduced on the Multi Commodity Exchange. By 2010, the market matured further with the introduction of futures contracts for other major global currencies, including the Japanese yen, the British pound, and the euro.

70. (B) Statistics validating NSE's rank were maintained exclusively by the Securities and Exchange Board of India (SEBI)
The global standing and rankings of derivatives exchanges are typically tracked and validated by international organizations such as the Futures Industry Association, rather than being maintained exclusively by domestic regulators like SEBI. The National Stock Exchange of India has gained significant international recognition, frequently ranking as the world's largest derivatives exchange based on the number of contracts traded, reflecting India's rapid growth.

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61. (C) Exchange-traded derivatives are more likely to have standardized contract terms
Exchange-traded derivatives are characterized by standardization, which means the contract sizes, expiration dates, and underlying asset qualities are uniform. This standardization promotes high liquidity and allows many participants to trade easily. Unlike over-the-counter derivatives, which are customized and carry higher bilateral credit risk, exchange-traded contracts are settled through a central clearinghouse that guarantees performance and reduces individual counterparty risk.

62. (A) Bombay Stock Exchange (BSE)
The Multi Commodity Exchange, National Multi Commodity Exchange, and National Commodity & Derivatives Exchange were all established around 2003 specifically to facilitate the trading of commodity-based derivatives in India. The Bombay Stock Exchange, however, is a much older institution primarily focused on equities and general securities. While BSE later introduced derivatives, it was not founded during the 2003 wave of commodity exchanges.

63. (C) A short position
An investor initiates a short position by borrowing a security and selling it at the current market price with the expectation of a future price decline. The goal is to repurchase the security later at a lower price, return the borrowed shares, and pocket the difference as profit. This bearish strategy allows investors to benefit from negative market movements and provides liquidity.

64. (C) Searching for a party willing to enter into the contracts
A major challenge in the over-the-counter market is the high search cost involved in finding a counterparty with matching needs. Because OTC contracts are customized rather than standardized, parties must directly negotiate terms like quantity, price, and expiration. This process is more difficult and less efficient than trading on an exchange, where a central order book automatically matches buyers and sellers.

65. (B) P-3, Q-2, R-4, S-1
Non-deliverable forwards are cash-settled contracts used for hedging, while the Futures Industry Association is a major global representative body for the industry. The National Multi Commodity Exchange and the National Commodity & Derivatives Exchange Limited are key Indian institutions that provide platforms for trading commodity-based derivative instruments. These organizations and products form the essential infrastructure of the modern derivatives market.

66. (D) A form of forward trading in equities that was eventually banned from the market
Badla was a traditional Indian system that allowed investors to carry forward their stock market positions from one settlement period to the next. Although it functioned as a form of forward trading, it was eventually banned by regulators to modernize the market and introduce more transparent, standardized derivative products. The replacement of badla marked a shift toward globally accepted exchange-traded derivative practices.

67. (A) (I), (II), (III), and (V)
A long position involves owning a security with the expectation that its price will rise, allowing the holder to "buy low and sell high." This position offers theoretically unlimited profit potential as there is no cap on how much an asset's value can increase. Unlike short positions, which involve borrowing and selling, the long position is based on direct ownership and a bullish outlook.

68. (A) These OTC trades were originally allowed only for non-resident foreign institutional investors
Over-the-counter derivatives in India, such as interest rate swaps and currency swaps, were allowed starting in 1999 for a broad range of domestic participants, including banks and primary dealers. They were not restricted solely to non-resident foreign institutional investors. These regulations aimed to deepen the financial markets by allowing domestic entities to manage interest rate and currency risks more effectively through private negotiations.

69. (A) 2, 3, 1
Currency futures in India were first launched for the U.S. dollar on the BSE and NSE in August 2008. Shortly after, in October 2008, they were

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historical development marked the beginning of structured derivative trading in India, long before the establishment of modern electronic stock and commodity exchanges.

36. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
A swap is structurally similar to a series of forward contracts because both are over-the-counter instruments that are privately negotiated between parties. Unlike futures, which are guaranteed by an exchange, swaps carry significant counterparty default risk as they depend on the creditworthiness of the participants. This lack of centralized clearing makes them flexible but riskier than standardized exchange-traded derivatives.

37. (A) A contract granting the right to buy or sell an asset at a fixed price
An option is a financial derivative that provides the buyer with the right to purchase or sell an underlying asset at a predetermined price within a specific timeframe. Crucially, the holder is not obligated to exercise this right if market conditions are unfavorable. This flexibility distinguishes options from forward commitments like futures, where performance is mandatory for both participating parties.

38. (D) (I), (II), and (III)
The introduction of equity derivatives in India began with index futures in June 2000, followed by index options in June 2001. Shortly thereafter, the market expanded to include individual stock options in July 2001 and stock futures in November 2001. These launches on the BSE and NSE marked a significant milestone in the modernization and diversification of Indian financial markets.

39. (D) P-4, Q-2, R-1, S-3
A hedge is an investment designed to reduce risk, while speculation involves trading assets to profit from price movements. Arbitrageurs are investors who exploit market price inefficiencies through simultaneous offsetting trades. Novation is the legal process where a clearinghouse replaces an original party in an agreement, effectively becoming the counterparty to all trades to ensure the performance of the contract.

40. (D) Long Position: Buy Low Sell High
A long position occurs when an investor purchases a security with the expectation that its market value will increase over time. By buying the shares at a lower price and selling them later at a higher price, the investor realizes a capital gain. This classic "buy low, sell high" strategy reflects a bullish outlook on the underlying asset's future performance.

41. (A) (I) and (II)
A short position follows the "sell high, buy low" strategy, where an investor profits from a decline in an asset's value. This involves selling a borrowed asset at the current market price with the intention of repurchasing it later at a lower price to return it. It is a bearish strategy used by investors who anticipate that the market will fall.

42. (C) An over-the-counter contract to exchange a series of cash flows over a period
A swap is a private agreement between two parties to exchange periodic cash flows over a specified duration based on an underlying variable. These over-the-counter contracts are highly customizable and commonly involve the exchange of interest rates, such as fixed for floating, or different currencies. Swaps allow institutions to manage long-term risks and adjust their financial exposure without trading physical assets.

43. (C) (I), (II), and (III)
NSE launched interest rate futures in 2003, but they were suspended in 2006 due to lack of trading interest. In 2009, new futures on ten-year government bonds were introduced to revive the market. While the 2003 contracts were based on a zero-coupon yield curve, the 2009 version focused on notional bond yields. Physical delivery and settlement mechanisms evolved throughout these periods.

44. (A) 3, 2, 1, 4
The history of Indian derivatives began with commodity futures trading by the Bombay Cotton Trade Association in 1875. Later, the government banned certain options and cash

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CHAPTER 35
Forward Contract

May/June 2019

1. What is the primary conceptual rationale for parties to enter into a forward contract?
(A) To maximize speculative returns based on unpredictable daily market price fluctuations.
(B) To benefit from the continuous compounding of the prevailing risk-free interest rate.
(C) To ensure immediate liquidity and cash settlement on the initial trade date.
(D) To lock in a price for a future transaction and avoid price uncertainty.

Oct/Nov 2014

2. Identify the correct pair representing the payoff and the breakeven point for a short forward contract.
(A) Payoff: S_T - F; Breakeven point: $S_T = 0$
(B) Payoff: S_T - F; Breakeven point: $S_T = F$
(C) Payoff: F - S_T; Breakeven point: $S_T = F$
(D) Payoff: F - S_T; Breakeven point: $F = 0$

May/June 2022

3. Which of the following details is NOT specified at the initiation of a forward contract?
(A) The specific counterparties involved in the contract
(B) The exact underlying asset to be exchanged
(C) The market spot price of the asset on the expiration date
(D) The forward price and the specific expiration date

Oct/Nov 2010

4. Identify the correct statement regarding Payoff and P&L in the context of a forward contract.
(A) Payoff and P&L are entirely unrelated and distinct concepts in the field of derivatives.
(B) The Payoff accounts for the initial margin paid, whereas the P&L calculation does not.
(C) P&L is the difference between cash flows at initiation and expiration, while Payoff is the expiration cash flow.
(D) A long forward's Payoff is always positive, but its final P&L can often be negative.

May/June 2006

5. What defines "counterparty risk" in the context of a forward contract?
(A) The risk that the market price of the asset will remain completely unchanged until expiration.
(B) The possibility that one party might renege and not fulfill their obligations.
(C) The risk that the underlying asset will incur excessive storage and insurance costs.
(D) The risk that an organized forward market cannot be found for the specific commodity.

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Oct/Nov 2020

6. What term is used to describe the nonmonetary advantage or benefit generated by holding certain commodities, often arising due to unusually tight supplies?
(A) Cost of carry
(B) Convenience yield
(C) Opportunity cost
(D) Forward premium

May/June 2015

7. Which of the following best defines a forward contract?
(A) An agreement to buy or sell a specified asset immediately at a price determined by current market conditions.
(B) An agreement to buy or sell an asset at a set future date for a price agreed upon today.
(C) An agreement granting the buyer the right, but not the obligation, to buy or sell an asset at a predetermined future date.
(D) A standardized contract traded on a public exchange to buy or sell an asset at a future date for a specified price and delivery terms.

(A) P-2, Q-4, R-3, S-1
(B) P-4, Q-2, R-1, S-3
(C) P-2, Q-3, R-4, S-1
(D) P-3, Q-1, R-2, S-4

May/June 2021

23. Finding a party with matching needs is a major problem in entering forward contracts. Which of the following is NOT specified as one of the matching needs?
(A) The quantity of goods being bought and sold must be the same.
(B) The quality of goods being bought and sold must be the same.
(C) The time of delivery by the seller must match the time at which the buyer needs the goods.
(D) The credit rating of the buyer and seller must be identical.

Oct/Nov 2007

24. A buyer and seller enter into a forward contract. At expiration, the long forward's P&L is +₹ 750. What will be the net forward P&L across the two counterparties?
(A) +₹ 1,500
(B) +₹ 750
(C) -₹ 750
(D) ₹ 0

May/June 2014

25. Match the long forward payoff scenarios in List I with their corresponding conditions in List II:
List I: (Long Forward Payoff Scenarios)
P. Positive payoff
Q. Negative payoff
R. Zero payoff
S. Long forward's breakeven point
List II: (Conditions)
1. $S_T = F$
2. The price of the asset received is less than the forward price paid
3. The price of the asset received is greater than the forward price paid
4. The underlying asset price at expiration equals the forward price
(A) P-3, Q-2, R-1, S-4
(B) P-2, Q-3, R-4, S-1
(C) P-3, Q-1, R-2, S-4
(D) P-1, Q-4, R-3, S-2

Oct/Nov 2012

26. Read the following statements regarding the key characteristics of a forward contract:
I The long forward is obligated to purchase an asset from the short forward at a future point in time.
II The short forward is obligated to sell the asset to the long forward at a future point in time.
Which of the statements is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2020

27. Which of the following best describes the approach used to determine the price of a financial asset?
(A) Discounting future cash flows and the predicted future price to their present value.
(B) Calculating the historical average of the asset's price over the last decade.
(C) Adding the convenience yield to the storage costs and ignoring interest rates.
(D) Equating the current spot price directly to the future forward price without adjustments.

Oct/Nov 2006

28. Which of the following statements correctly highlights a characteristic of forward contracts?
(A) Forward contracts are flexible with respect to amount, quality, and delivery details.
(B) Forward contracts are rigid instruments with fixed amounts and standardized delivery details.
(C) Forward contracts are traded exclusively on regulated central financial exchanges.
(D) Forward contracts completely eliminate the risk of non-performance by either party.

May/June 2011

29. Which of the following statements regarding the P&L diagram of a forward contract is incorrect?
(A) The horizontal axis represents the underlying asset price at expiration.
(B) The vertical axis represents the P&L of the position.

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May/June 2005

15. An investor buys a stock that costs ₹ 60 in a market where the risk-free rate of interest is 10%. By compounding the price paid to a future value one year later, what is the effective price paid for the asset?
(A) ₹ 60
(B) ₹ 70
(C) ₹ 54
(D) ₹ 66

Oct/Nov 2025

16. Since which year have forward contracts on currency and interest rates been in existence in India?
(A) 1947
(B) 1973
(C) 1991
(D) 2000

May/June 2018

17. The concept that any profit one counterparty receives in a forward contract is exactly equal to the loss that the other counterparty suffers defines forwards as:
(A) A zero-sum game
(B) A positive-sum game
(C) A continuous compounding transaction
(D) A marked-to-market agreement

Oct/Nov 2017

18. Which of the following best describes how a forward contract affects the financial position of the parties involved?
(A) It eliminates price uncertainty but results in a gain or loss based on asset price movements.
(B) It guarantees a net profit for the long forward position at the time of expiration.
(C) It ensures that neither party will incur an opportunity cost during the holding period.
(D) It provides a continuous stream of interim cash flows throughout the life of the contract.

May/June 2024

19. A short forward contract is initiated on May 3 and expires on June 1. The forward price is ₹ 55. If the underlying asset price on June 1 is ₹ 80, what is the Short Forward Payoff?
(A) ₹ 25
(B) ₹ 135
(C) -₹ 80
(D) -₹ 25

Oct/Nov 2011

20. Read the following statements regarding the payoff of a forward contract, where S_T is the underlying asset price at expiration and F is the forward price:
I The long forward's payoff is represented by the equation $S_T - F$.
II The short forward's payoff is represented by the equation $F - S_T$.
III A positive payoff occurs for the long forward when $S_T < F$
Which combination of statements is correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

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May/June 2008

21. Ravish and Dindayal agree on a forward price of ₹ 40 per kg for 50 MT of rice. If the harvest is very good and the market price drops to ₹ 35 per kg, what is the result for both parties?
(A) Ravish loses ₹ 5 per kg; Dindayal gains ₹ 5 per kg.
(B) Both parties gain ₹ 5 per kg due to the good harvest.
(C) Ravish gains ₹ 5 per kg; Dindayal loses ₹ 5 per kg.
(D) Both parties face zero payoff as the contract is nullified.

Oct/Nov 2016

22. Match the counterparties and terms in List I with their obligations or descriptions in List II:
List I: (Counterparties and Terms)
P. Long position
Q. Short position
R. Underlying asset
S. Expiration date
List II: (Obligations or Descriptions)
1. The future point in time when the transaction occurs
2. Obligated to purchase an asset at a future point in time
3. Any asset such as stocks, bonds, currencies, or commodities
4. Obligated to sell the asset at a future point in time

Oct/Nov 2024

8. Ravish, a farmer, agrees on September 1 to sell 50 MT of rice to Dindayal on January 31 at a forward price of ₹ 40 per kg. If the market price of rice in January turns out to be ₹ 45 per kg, what is the financial outcome of this contract for Ravish?
(A) Ravish makes a gain of ₹ 5 per kg.
(B) Ravish suffers a loss of ₹ 5 per kg.
(C) Ravish breaks even and faces zero payoff.
(D) Ravish suffers a loss of ₹ 45 per kg.

May/June 2009

9. In a P&L diagram for a short forward position, if the underlying asset price at expiration (S_T) is less than the forward price (F), what does the diagram indicate?
(A) The P&L is negative, and the short forward suffers a loss.
(B) The P&L is positive, and the short forward earns a profit.
(C) The short forward is at its breakeven point.
(D) The long forward earns a negative P&L.

Oct/Nov 2013

10. Arrange the following events in the lifecycle of a typical forward contract in the correct chronological order:
I The counterparties agree upon a forward price and an expiration date.
II The long forward pays the forward price and receives the underlying asset.
III The expiration date arrives.
IV No transaction or exchange of cash/asset takes place.
(A) (I), (IV), (III), (II)
(B) (I), (II), (III), (IV)
(C) (IV), (I), (II), (III)
(D) (I), (III), (IV), (II)

May/June 2023

11. Which of the following assets is NOT typically associated with significant storage costs that must be factored into the cost of carry?
(A) Wheat
(B) Oil
(C) Gold
(D) Financial bonds

Oct/Nov 2008

12. Read the following statements regarding forward contracts:
I The underlying asset in a forward contract is limited exclusively to agricultural commodities.
II The forward price is set at initiation though the transaction takes place in the future.
III At initiation, no transaction takes place between the long and short forward.
IV The future point in time when the transaction occurs is known as the expiration date.
V A forward contract eliminates price uncertainty for both parties.
Which combination of statements is correct?
(A) (I), (II), (III), and (IV) only
(B) (II), (III), (IV), and (V) only
(C) (I), (III), (IV), and (V) only
(D) (I), (II), (IV), and (V) only

May/June 2012

13. An investor enters into a long forward contract on January 10 with an expiration date of March 15. The forward price is ₹ 1,500. On March 15, the underlying asset price is ₹ 1,200. What is the long forward's P&L?
(A) -₹ 300
(B) ₹ 300
(C) ₹ 2,700
(D) -₹ 1,200

Oct/Nov 2021

14. Read the following Assertion (A) and Reason (R) and choose the correct option from the choices given below:
Assertion (A): Counterparty risk is always present in forward contracts and cannot be eliminated.
Reason (R): The fact that the asset price may move against a party creates a financial incentive for that party to renege on the contract.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

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(C) The upward diagonal line from bottom-left to top-right represents the short's P&L.
(D) The short forward's breakeven point is identical to the long forward's breakeven point.

Oct/Nov 2019

30. Read the following statements regarding forward contracts:
I Financial intermediaries such as banks act as middlemen in bringing parties together for currency or interest rate forwards.
II Using a financial intermediary eliminates the risk of non-performance in an over-the-counter forward contract.
Which of the statements is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2013

31. Match the notations in List I with their standard definitions in List II for forward contract valuation:
List I: (Notations)
P. f_t
Q. F
R. T
S. S_t
List II: (Standard Definitions)
1. Underlying asset price at time t
2. Long forward value
3. Expiration date
4. Forward price
(A) P-2, Q-4, R-3, S-1
(B) P-4, Q-2, R-1, S-3
(C) P-1, Q-3, R-4, S-2
(D) P-2, Q-1, R-3, S-4

Oct/Nov 2022

32. Match the metric in List I with its correct formulation for a Long Forward in List II:
List I: (Metric)
P. Payoff
Q. Value
R. Forward price (discrete compounding)
S. Forward price (continuous compounding)
List II: (Formulation for a Long Forward)
1. $F = S_t e^{r(T-t)}$
2. $F = S_t(1+r)^{(T-t)}$
3. $S_T - F$
4. $f_t = S_t - F(1+r)^{-(T-t)}$
(A) P-3, Q-4, R-2, S-1
(B) P-4, Q-3, R-1, S-2
(C) P-3, Q-2, R-4, S-1
(D) P-2, Q-4, R-3, S-1

May/June 2025

33. Identify the incorrect pair linking an asset type with its holding cost or benefit.
(A) Bonds – Coupon interest
(B) Currencies – Storage costs
(C) Commodities – Convenience yield
(D) Stocks – Dividend payments

Oct/Nov 2009

34. A forward contract obligates the long forward to purchase an asset in three years. The underlying asset price at initiation is ₹ 85, and the continuously compounded risk-free rate is 5%. What is the forward price?
(A) ₹ 89.25
(B) ₹ 103.45
(C) ₹ 80.75
(D) ₹ 98.76

May/June 2017

35. Which of the following best explains the difference between the theoretical forward price and the negotiated forward price?
(A) Theoretical price is the compounded spot price, while negotiated price may differ in reality.
(B) The theoretical forward price includes counterparty risk, while the negotiated price does not.
(C) The theoretical forward price changes daily, whereas the negotiated price applies only at expiration.
(D) The theoretical forward price applies only to commodities, whereas the negotiated price applies to financial assets.

Oct/Nov 2023

36. Which of the following defines a Forward Rate Agreement (FRA)?
(A) An OTC contract to exchange interest payments for a notional principal on a settlement date.
(B) An exchange-traded derivative used to facilitate the physical delivery of agricultural goods at a future date.
(C) A contract that grants the buyer the

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18. (A) It eliminates price uncertainty but results in a gain or loss based on asset price movements.
Entering a forward agreement allows parties to fix the price of a future transaction, thereby eliminating the risk of adverse price movements. While this provides certainty for budgeting and planning, the final financial outcome depends on the actual market price at expiration. Participants will experience either a gain or a loss relative to the market price, depending on the price direction.

19. (D) -₹ 25
For a short forward position, the payoff is calculated by subtracting the market price at expiration from the agreed forward price. If the market price rises above the contract rate, the seller is obligated to deliver the asset at a discount to its current value. This difference represents a negative payoff for the seller at the time of final settlement.

20. (A) (I) and (II) only
The payoff of a forward contract is a linear function of the asset price at maturity. A long position gains value when the spot price exceeds the forward price, while a short position gains value when the spot price falls below the forward price. These mathematical relationships define the financial obligations and potential outcomes for both participants in the derivative agreement.

21. (C) Ravish gains ₹ 5 per kg; Dindayal loses ₹ 5 per kg.
When the market price of an asset falls below the agreed forward price, the seller benefits by receiving a higher-than-market rate. Conversely, the buyer incurs a loss because they are forced to pay more than the asset's current market value. This specific outcome illustrates the transfer of value between counterparties based on the direction of price movements after contract initiation.

22. (A) P-2, Q-4, R-3, S-1
In the context of forward contracts, specific roles and terms define the agreement. The long position is the buyer, while the short position is the seller. The underlying asset refers to the specific security or commodity being traded, and the expiration date denotes the exact time when the parties must fulfill their contractual obligations and complete the transaction as agreed.

23. (D) The credit rating of the buyer and seller must be identical.
Successful forward negotiations require a double coincidence of wants regarding the specific quantity, quality, and delivery timing of the asset. While both parties must agree on these physical and temporal terms, their individual credit ratings do not need to be the same. The primary concern is simply that each party finds the other's creditworthiness acceptable for the trade.

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24. (D) ₹ 0
Because a forward contract is a bilateral agreement where one party's profit is the other's loss, the combined profit and loss for both participants is always zero. This zero-sum nature ensures that no net value is generated or destroyed by the contract itself. The gains of the winner are perfectly offset by the losses of the counterparty.

25. (A) P-3, Q-2, R-1, S-4
The payoff for the long forward position depends entirely on the relationship between the final spot price and the agreed forward price. A profit occurs when the spot price is higher, while a loss occurs when it is lower. If both prices are equal, the payoff is zero, which is known as the breakeven point for the participant.

26. (C) Both (I) and (II) are correct
A forward contract creates a dual obligation where both parties are legally bound to perform. The buyer, or long position, is committed to purchasing the asset, while the seller, or short position, is committed to delivering it. These mutual promises are established at the beginning and must be fulfilled at the specified future date regardless of prevailing market conditions.

27. (A) Discounting future cash flows and the predicted future price to their present value.
The valuation of a financial asset is fundamentally based on the principle of present value. This approach involves estimating all

is ₹ 90. The underlying asset price is ₹ 95. What is the value of the long forward?
(A) -₹ 11.50
(B) ₹ 11.50
(C) ₹ 5.00
(D) -₹ 5.00

May/June 2019

44. Read the following Assertion (A) and Reason (R) and choose the correct option from the choices given below:
Assertion (A): At the initiation date of a forward contract, the net present value of the contract is zero.
Reason (R): Neither the long nor the short pays anything to the other at the initiation date, as the contract is designed to be fair to both.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2020

45. Consider an 11-month forward contract on a stock priced at ₹ 75. The present value of expected dividends over the contract period is calculated as ₹ 0.7210. The risk-free rate compounding factor for 11 months is 1.0753. Compute the forward price.
(A) ₹ 80.65
(B) ₹ 74.28
(C) ₹ 79.91
(D) ₹ 81.43

May/June 2015

46. Read the following Assertion (A) and Reason (R) and choose the correct option from the choices given below:
Assertion (A): For financial assets, storage costs are safely ignored when determining the cost of carry.
Reason (R): Unlike physical commodities, financial assets do not require significant physical space, protection against theft, or destruction insurance.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2021

47. Read the following statements for computing the forward price of a dividend-paying stock:
I The present value of each expected dividend is computed individually using the appropriate discount rate.
II The sum of the present values of these dividends is subtracted from the current stock price before applying the compounding factor for the contract duration.
Which of the statements is/are correct?
(A) Only (I) is correct
(B) Only (II) is correct
(C) Both (I) and (II) are correct
(D) Neither (I) nor (II) is correct

May/June 2006

48. Which of the following best explains why a forward contract is designed to have zero value at initiation?
(A) The spot price is assumed to be zero at the exact moment the contract is signed.
(B) A "fair" price is chosen such that neither party has an initial asset or liability.
(C) Forward contracts do not legally bind the counterparties until the expiration date occurs.
(D) The risk-free rate of interest is deducted entirely from the spot price on day zero.

Oct/Nov 2014

49. The underlying price S_t is ₹ 500, the risk-free rate r is 6% monthly compounded, and the contract expires in three months. Calculate the theoretical forward price.
(A) ₹ 507.54
(B) ₹ 500.00
(C) ₹ 530.00
(D) ₹ 590.22

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May/June 2022

50. What key property must the forward price possess at the initiation date of the contract?
(A) It must guarantee a minimum profit of 5% for the long position.
(B) It must be equal to exactly half of the underlying spot price.
(C) It must result in the contract having zero value and prohibit arbitrage.
(D) It must match the expected future spot price minus all dividend yields.

Oct/Nov 2010

51. Read the following statements regarding the characteristics of a Forward Rate Agreement (FRA):
I The two counterparties agree to a notional principal amount that does not change hands.
II The buyer of the FRA agrees to pay a fixed-rate interest payment and receive a floating-rate payment.
III The seller of the FRA receives the fixed-rate payment and pays the floating-rate payment.
IV FRAs are typically settled physically by exchanging the full principal.
V FRAs are cash-settled at the settlement date with no interim cash flows.
Which combination of statements is correct?
(A) (I), (II), (III), and (V)
(B) (I), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (IV), and (V)

May/June 2023

52. You enter a forward contract to buy a used car in one year for ₹ 2,00,000. One year later, an identical car in the market is worth ₹ 3,00,000. What is the value of your forward contract at expiration?
(A) ₹ 2,00,000
(B) ₹ 3,00,000
(C) -₹ 1,00,000
(D) ₹ 1,00,000

Oct/Nov 2013

53. Read the following statements regarding formulas associated with forward contracts:
I Long forward value: $f_t = S_t - F(1+r)^{-(T-t)}$
II Short forward value: $-f_t = F(1+r)^{-(T-t)} - S_t$
III Forward value at initiation: $f_t = S_t - F$
Which of the statements is/are correct?
(A) (I) and (II) only
(B) (II) and (III) only
(C) (I) and (III) only
(D) (I), (II), and (III)

May/June 2009

54. Which of the following statements about pricing a forward contract on an investment with known income is incorrect?
(A) The expected future dividends or coupons must be subtracted from the spot price to find the base value to compound.
(B) The present value of the income I is calculated during the life of the contract.
(C) A higher dividend yield will mathematically increase the forward price of a stock.
(D) The forward price formula adjusts for the fact that the long forward does not receive the interim cash flows prior to expiration.

Oct/Nov 2008

55. Identify the correct statement explaining the logic behind compounding the spot price to determine the forward price.
(A) Forward contracts delay payment, meaning the investor does not forego interest until expiration.
(B) Buying the asset today avoids the risk-free interest cost, so the forward price must be lower than the spot price.
(C) The forward price is calculated by discounting the spot price because the future value of money is always lower.
(D) The forward price ignores the spot price entirely and relies only on the risk-free interest rate.

NODIA

May/June 2012

56. Which of the following highlights the conceptual difference between the "price" and the "value" of a forward contract?
(A) Price is the agreed transaction amount, while value is the worth of the position.
(B) Price is the current market spot rate, whereas value is the agreed future transaction amount.
(C) Price changes daily with market fluctuations, whereas value is fixed at initiation.
(D) Price is relevant only for short forwards, whereas value applies exclusively to long

forwards.

Oct/Nov 2025

57. A 6-month forward contract is written on a coupon-bearing bond currently priced at ₹ 1200. A coupon payment with a present value of ₹ 59.41 is expected before expiration. The 6-month risk-free rate is 4% p.a. compounded monthly. Using the standard formula $F = (S_t - I)(1 + r)^{(T-t)}$ and assuming the compounding factor$(1 + \frac{0.04}{12})^6 \approx 1.02$, calculate the forward price.
(A) ₹ 1163.40
(B) ₹ 1224.00
(C) ₹ 1284.60
(D) ₹ 1140.59

May/June 2005

58. An investor entered into a long forward contract. The forward has 3 months remaining until expiration. The monthly compounded risk-free interest rate is 6%. The forward price is ₹ 1,000. The underlying asset price is ₹ 920. What is the approximate forward value for the long position?
(A) -₹ 65.15
(B) ₹ 65.15
(C) -₹ 80.00
(D) ₹ 80.00

Oct/Nov 2017

59. Identify the correct pair linking the investment scenario with its appropriate forward price formula.
(A) Investment generating continuous dividend yield: $F = (S_t + I)(1 + r)^{(T-t)}$
(B) Asset with no intermediate income (continuous compounding): $F = S_t e^{-r(T-t)}$
(C) Investment with known income I (discrete compounding): $F = (S_t - I)(1 + r)^{(T-t)}$
(D) Commodity with high storage costs: $F = S_t - I$

May/June 2018

60. Read the following statements regarding the status of a forward contract after initiation:
I If the forward value becomes positive for a counterparty, it acts as an asset.
II If the forward value becomes negative for a counterparty, it acts as a liability.
III The sum of the long forward value and the short forward value is always positive.
IV Because a forward is a zero-sum game, a positive value for one position is exactly offset by the negative value of the other.
Which combination of statements is correct?
(A) (I), (II), and (III) only
(B) (I), (II), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (III), and (IV) only

Oct/Nov 2011

61. Read the following statements regarding the usages of an FRA:
I Market participants use them to hedge future borrowing against rising interest rates.
II Market participants use them to hedge future lending against falling interest rates.
III Traders use them to speculate on the future development of interest rates.
IV Arbitrageurs use them to exploit price differences between an FRA and other interest rate instruments.
Which combination of statements is correct?
(A) (I), (II), and (III) only
(B) (I), (III), and (IV) only
(C) (II), (III), and (IV) only
(D) (I), (II), (III), and (IV)

May/June 2024

62. Identify the incorrect pair linking FRA terminology to its description.
(A) Contract rate – The interest rate the two contracting parties negotiate on trade date.
(B) Fixing date – The date on which the notional loan is deemed to expire.
(C) Waiting period – The period comprised between the value date and the settlement date.
(D) Reference rate – The interest rate index the FRA rate will be compared against.

Oct/Nov 2016

63. Arrange the following dates in the lifecycle of an FRA in the correct chronological order:
I Settlement date
II Fixing date
III Trade date
IV Maturity date
(A) (III), (I), (II), (IV)
(B) (III), (II), (I), (IV)

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ANSWERS

1. (D) To lock in a price for a future transaction and avoid price uncertainty.
Forward contracts serve as a risk management tool used by market participants to mitigate the volatility associated with future price changes. By entering into an agreement today to transact at a specific price on a future date, both the buyer and the seller eliminate uncertainty and establish a fixed cost or revenue for their operations at the time of maturity.

2. (C) Payoff: $F - S_T$; Breakeven point: $S_T = F$
A short forward position involves an obligation to sell an underlying asset at a predetermined price. The payoff for this position is calculated as the difference between the agreed contract price and the market price at expiration. Financial neutrality or the breakeven point occurs specifically when the spot price at maturity equals the initially agreed forward price for the trade.

3. (C) The market spot price of the asset on the expiration date
At the inception of a forward agreement, key terms such as the quality and quantity of the asset, the specific counterparties, and the delivery date are fixed. However, the future market spot price remains unknown until the contract matures. This inherent unpredictability of the final market price is the primary reason why parties use these derivatives to manage risk.

4. (C) P&L is the difference between cash flows at initiation and expiration, while Payoff is the expiration cash flow.
In derivative markets, the payoff represents the gross cash flow realized by a position at the moment of contract expiration. Conversely, profit and loss is a broader measure that considers the net difference between all cash outflows at initiation and the final payoff. This distinction is vital for accurately assessing the overall financial performance and efficiency of any derivative trade.

5. (B) The possibility that one party might renege and not fulfill their obligations.
Counterparty risk refers to the potential financial loss arising from the failure of one party to fulfill their contractual obligations. In over-the-counter markets where forward contracts are negotiated, there is no central clearinghouse to guarantee trades. Consequently, if the market price moves significantly against a participant, they may have a financial incentive to default on the agreed terms.

6. (B) Convenience yield
Physical commodities often provide nonmonetary benefits to their owners, particularly during periods of market shortages or supply chain disruptions. This advantage is known as the convenience yield, which reflects the value of having immediate access to physical goods. This yield typically reduces the theoretical forward price of the commodity relative to its current market spot price in the financial model.

NODIA

7. (B) An agreement to buy or sell an asset at a set future date for a price agreed upon today.
A forward contract is a customized financial derivative where two parties agree to conduct a transaction involving an underlying asset at a specified future date. The price for this future trade is determined and locked in at the time of the agreement. This binding obligation ensures that both participants are protected from subsequent fluctuations in market price levels until expiration.

8. (B) Ravish suffers a loss of ₹ 5 per kg.
When a seller enters a forward contract to deliver goods at a fixed price, they face a financial loss if the market price at delivery exceeds that fixed price. In this scenario, the market value of the rice is higher than the agreed rate. Consequently, the seller experiences an opportunity cost equal to the difference between these two specific values.

May/June 2020

70. Alpha Ltd entered into a 3 × 6 FRA with ABC Bank on a notional principal of ₹ 5 crore. Alpha Ltd (the FRA buyer) agreed to pay an FRA rate of 8.00%. On the fixing date, the benchmark settlement rate is determined to be 7.00%. The contract period covers 90 days. Based on the interest differential formula, what is the nature of the cash flow before discounting?

(A) Alpha Ltd receives the interest differential from ABC Bank because the settlement rate is lower than the contract rate.

(B) Alpha Ltd pays the interest differential to ABC Bank because the contract rate is higher than the settlement rate.

(C) No settlement amount is paid because the notional principal does not change hands.

(D) Both parties pay each other 7.50% to average the difference.

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option to lock in an exchange rate without any legal obligation.

(D) A continuous settlement mechanism that adjusts the notional principal based on daily interest rate fluctuations.

May/June 2016

37. Read the following statements regarding the benefits and costs of holding assets:

I The net of the costs and benefits of holding an asset is often referred to as the cost of carry.

II Interest payments on bonds and currencies are relatively uncertain compared to dividends.

III Opportunity cost is reflected by compounding the price paid for the asset to a future value at the risk-free rate.

IV Convenience yields are primarily associated with financial assets rather than commodities.

Which combination of statements is correct?

(A) (I) and (III) only

(B) (II) and (IV) only

(C) (I), (III), and (IV) only

(D) (I), (II), and (III) only

Oct/Nov 2018

38. What is the correct formula to calculate the theoretical forward price if the interest rate is compounded continuously?

(A) $F = S_t(1+r)^{(T-t)}$

(B) $F = S_t e^{-r(T-t)}$

(C) $F = S_t - e^{r(T-t)}$

(D) $F = S_t e^{r(T-t)}$

May/June 2007

39. Read the following statements regarding forward contracts on an investment with known income:

I Examples include coupon bonds and dividend-paying stocks.

II The present value of the expected income over the life of the contract is added to the spot price before compounding.

III The income generated by the asset reduces the theoretical forward price compared to an asset without income.

Which of the statements is/are correct?

(A) (I) and (II) only

(B) (I) and (III) only

(C) (II) and (III) only

(D) (I), (II), and (III)

Oct/Nov 2015

40. Read the following statements regarding the determinants of forward value:

I The underlying asset price on the valuation date

II The initial forward price

III The credit rating of the short forward

IV The risk-free interest rate on the valuation date

V The time to expiration

Which combination represents the correct determinants of a forward contract's value after initiation?

(A) (I), (II), (III), and (V)

(B) (I), (II), (IV), and (V)

(C) (II), (III), (IV), and (V)

(D) (I), (III), (IV), and (V)

NODIA

May/June 2010

41. In FRA notation, what does a "3×6FRA" denote?

(A) An FRA with a 3-month contract period and a 6-month total maturity.

(B) An FRA having a 3-month waiting period and a 3-month contract period.

(C) An FRA having a 3-month waiting period and a 6-month contract period.

(D) An FRA with 3 counterparties and a 6-month settlement cycle.

Oct/Nov 2005

42. Which of the following statements regarding the forward price and forward value is incorrect?

(A) At initiation, the forward value is zero for both the long and short positions.

(B) The forward price is determined at initiation and does not change over the life of the forward.

(C) The forward price is adjusted daily to ensure the forward value remains zero.

(D) The forward value will inevitably change as the determinants of value fluctuate.

Oct/Nov 2024

43. An investor entered into a long forward contract with 1.50 years remaining until expiration. The continuously compounded risk-free interest rate is 5%. The forward price

9. (B) The P&L is positive, and the short forward earns a profit.
In a short forward position, the participant benefits when the market price of the underlying asset declines below the pre-agreed contract price. If the spot price at expiration is less than the forward price, the seller effectively sells the asset for more than its current worth. This results in a positive profit and loss for the short position holder.

10. (A) (I), (IV), (III), (II)
The lifecycle of a forward contract begins with the negotiation of terms and the setting of a forward price. Following initiation, no cash or assets change hands during the holding period. Upon reaching the expiration date, the contract matures, and the final settlement occurs where the buyer pays the agreed price to receive the underlying asset from the seller.

11. (D) Financial bonds
Physical commodities such as agricultural products, energy resources, and precious metals incur significant costs related to warehousing, insurance, and physical security. Financial assets, including stocks and bonds, generally exist in electronic or paper form and do not require expensive physical storage. Therefore, storage costs are typically negligible or zero when calculating the cost of carry for these financial instruments.

12. (B) (II), (III), (IV), and (V) only
Forward contracts are versatile instruments applicable to various underlying assets, including financial securities and currencies. While no money is exchanged at initiation, the price is fixed to eliminate future uncertainty. These contracts expire on a specific date when the transaction is completed. Consequently, they serve as effective tools for both parties to manage and stabilize future cash flow requirements and risks.

13. (A) -₹ 300
The financial performance of a long forward position is determined by subtracting the agreed forward price from the market spot price at maturity. If the asset price drops below the contract price, the holder of the long position suffers a loss. In this case, the difference represents a negative return because the buyer is obligated to pay a price premium.

14. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Counterparty risk is an inherent feature of over-the-counter forward contracts because they lack the guarantee of a central exchange. As market prices fluctuate, one party may find themselves in a significant loss position, creating a strong motivation to default on their obligation. This direct link between price movements and the incentive to renege explains why this credit risk persists.

15. (D) ₹ 66
The effective price of an asset purchased today for future delivery must account for the opportunity cost of capital. By applying the risk-free interest rate to the current cost, one calculates the future value of that investment. This compounding process reflects what the funds would have earned elsewhere, establishing the total economic cost of acquiring the asset over time.

16. (B) 1973
The historical development of financial derivatives in India includes the introduction of forward contracts for managing currency risks. These instruments have been utilized by institutions and corporations since 1973 to hedge against volatility in the foreign exchange markets. This established a foundation for the more complex derivative markets that evolved in subsequent decades within the country.

17. (A) A zero-sum game
Forward contracts are characterized as zero-sum games because the total wealth of the participants remains constant. Any financial gain realized by the long position is mathematically identical to the financial loss incurred by the short position, and vice versa. There is no net creation of value within the contract itself; it merely redistributes wealth based on market price movements.

NODIA

(C) (II), (III), (I), (IV)
(D) (I), (III), (II), (IV)

May/June 2008

64. Read the following Assertion (A) and Reason (R) and choose the correct option from the choices given below:
Assertion (A): The buyer of an FRA will receive cash from the seller if the actual settlement rate is greater than the agreed contract rate.
Reason (R): The buyer of an FRA effectively borrows at the fixed contract rate; thus, if the floating market rate (settlement rate) rises above it, the buyer benefits and receives the difference.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2007

65. Match the FRA terminology in List I with its description in List II:
List I: (FRA Terminology)
P. Settlement Amount
Q. Notional amount
R. Reference rate
S. Contract period
List II: (Description)
1. The time between the settlement date and maturity date of the notional loan.
2. The interest rate index the FRA rate will be compared against.
3. The notional sum on which all interest calculations will be based.
4. The amount calculated as the difference between the FRA rate and the reference rate as a percentage of the notional sum.
(A) P-4, Q-3, R-2, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-4, Q-2, R-3, S-1
(D) P-1, Q-3, R-2, S-4

May/June 2021

66. Which of the following statements correctly identifies the obligations in an FRA?
(A) The buyer of an FRA is the party that lends at the FRA rate.
(B) The seller of an FRA receives the floating-rate payment and pays the fixed-rate payment.
(C) Both buyer and seller exchange the notional principal on the fixing date.
(D) The buyer of an FRA borrows at the FRA rate, effectively paying fixed and receiving floating.

Oct/Nov 2012

67. Which of the following best describes how the settlement amount in an FRA is executed?
(A) The full notional principal plus the interest rate differential is paid at maturity.
(B) Periodic cash flows are exchanged monthly throughout the contract period.
(C) Cash settlement occurs on the trade date based on the prevailing yield curve.
(D) The interest differential is paid upfront on the settlement date, discounted using the settlement rate.

May/June 2014

68. Which of the following statements regarding the weaknesses or risks of an FRA is incorrect?
(A) FRAs are marked-to-market daily and require the posting of daily collateral.
(B) FRAs are subject to default risk or counterparty risk.
(C) There is no clearinghouse to guarantee performance of an FRA.
(D) It can sometimes be difficult to find a specific counterparty wanting to take exactly the opposite position.

Oct/Nov 2006

69. Which of the following is NOT an intended usage or feature of a Forward Rate Agreement (FRA)?
(A) Hedging future borrowing against adverse movements in interest rates.
(B) Eliminating counterparty risk entirely through the use of a clearinghouse.
(C) Trading based on expectations of future development of interest rates.
(D) Taking advantage of price differences in arbitrage strategies.

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future cash flows, such as dividends or interest, and the expected eventual sale price, then discounting these amounts back to the present. This methodology ensures that the current price reflects the time value of money and the expected future benefits.

28. (A) Forward contracts are flexible with respect to amount, quality, and delivery details.
Forward contracts are highly flexible instruments because they are negotiated privately between two parties in the over-the-counter market. This allows the participants to customize every aspect of the agreement, including the exact quantity of the asset, its specific quality, and the precise location and timing of delivery. This flexibility distinguishes forwards from standardized exchange-traded futures contracts.

29. (C) The upward diagonal line from bottom-left to top-right represents the short's P&L.
In a standard profit and loss diagram for derivatives, the line representing a short forward position slopes downwards from the top-left to the bottom-right. This indicates that as the price of the underlying asset increases, the short position's profit decreases and eventually becomes a loss. An upward-sloping diagonal line correctly describes the long position's profit and loss profile.

30. (A) Only (I) is correct
Banks and other financial institutions often serve as intermediaries to facilitate forward contracts, helping parties with matching needs find one another. While these middlemen streamline the process and may have higher creditworthiness, their presence does not entirely eliminate counterparty risk. The potential for default remains a factor in any over-the-counter agreement between two private entities or individuals.

31. (A) P-2, Q-4, R-3, S-1
Standardized mathematical notations are used to define the components of forward contract valuation. These symbols represent the current price of the underlying asset, the agreed-upon forward price, the date when the contract expires, and the current value of the contract itself. Using these consistent labels allows for the precise calculation of gains and losses during the life of the derivative.

32. (A) P-3, Q-4, R-2, S-1
The valuation of long forward positions involves specific formulas for payoff, current value, and theoretical pricing. Payoff is the settlement amount at maturity, while value represents the present value of the expected payoff before expiration. Theoretical prices can be calculated using either discrete or continuous compounding methods, depending on the interest rate conventions applied to the specific underlying asset.

33. (B) Currencies – Storage costs
Different asset classes involve varying types of carrying costs or benefits. While commodities often require physical storage and bonds generate periodic coupon interest, currencies are typically held in interest-bearing accounts. Therefore, linking currencies to physical storage costs is inaccurate, as their primary financial characteristic is the generation of interest income rather than the incurrence of warehousing or insurance expenses.

NODIA

34. (D) ₹ 98.76
To determine the theoretical forward price with continuous compounding, the current spot price is multiplied by the exponential of the risk-free rate and the time to maturity. This calculation accounts for the opportunity cost of capital over the three-year period. By applying this mathematical model, one finds that the future price must compensate the seller for deferred payment.

35. (A) Theoretical price is the compounded spot price, while negotiated price may differ in reality.
The theoretical forward price is a calculated value based on mathematical models like the cost-of-carry, assuming perfect market conditions. In contrast, the negotiated forward price is the actual rate agreed upon by the counterparties in a real transaction. Discrepancies between these two values can occur due to market frictions, transaction costs, or differing expectations of the various market participants.

CHAPTER 36
Futures

Oct/Nov 2021

1. What is the lot size and notional bond face value for interest rate futures traded in India?
(A) 1000 bonds with a notional face value of ₹ 1,0,000
(B) 2000 bonds with a notional face value of ₹ 2,0,000
(C) 5000 bonds with a notional face value of ₹ 5,0,000
(D) 10,000 bonds with a notional face value of ₹ 10,0,000

May/June 2014

2. Identify the incorrect statement regarding the pricing of future contracts.
(A) The value of the futures is based on the cost of the carry model.
(B) The actual price of futures can be influenced by the demand and supply for the contract in the exchanges.
(C) The method of determination of futures prices is fundamentally different from that used for forward contracts.
(D) The futures price should normally be equal to the monetary value of the risk which needs to be assessed.

Oct/Nov 2006

3. What does the term "convenience yield" refer to in the futures market?
(A) The additional margin required by the clearinghouse to cover excessive credit risk.
(B) The premium paid by the buyer to the seller for entering into a forward contract over the counter.
(C) The implied return on warehouse inventory derived from holding physical material to keep production processes running.
(D) The cost associated with storage, financing, and insurance of the physical asset.

May/June 2010

4. What is the most appropriate reason why the futures price converges to the spot price at expiration?
(A) The exchange enforces mandatory rules requiring all cash settlement amounts to equal the previous day's closing.
(B) Clearinghouse variation margins adjust initial margins to mathematically match the spot price on the final day.
(C) Market efficiency and arbitrage ensure the price reflects that the short delivers assets while the long pays spot.
(D) Regulatory bodies impose strict price ceilings and floors that force futures prices to match the spot markets.

Oct/Nov 2014

5. How does the clearinghouse manage the credit risk it assumes in futures transactions more flexibly than in forward contracts?
(A) By requiring the entirety of the transaction payoff to be made only at the final moment of contract expiration.
(B) By settling gains and losses on a daily basis, which significantly reduces the potential default exposure.
(C) By ensuring that the contract size remains sufficiently large to trigger a default event only very selectively.
(D) By tailoring the specific delivery dates and physical modes of delivery for each individual trade counterparty.

May/June 2018

6. What is the most appropriate action if a margin account balance falls below the maintenance margin and the trader fails to provide the required additional funds?
(A) The clearinghouse automatically extends a credit line to cover the deficit until expiration.
(B) The broker has the right to close out the trader's position and update the margin

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45. (C) ₹ 79.91
To calculate the forward price of a dividend-paying stock, the present value of the expected dividends must first be subtracted from the current spot price. This adjusted base is then multiplied by the interest rate compounding factor for the relevant period. This method accounts for the fact that the forward buyer does not receive the dividends during the contract's life.

46. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Storage costs are a significant factor in the cost of carry for physical commodities because they require warehousing and protection. In contrast, financial assets are generally held in digital or paper form, making their physical maintenance costs negligible. For this reason, practitioners safely omit storage expenses when calculating the theoretical forward prices for instruments like stocks or bonds.

47. (C) Both (I) and (II) are correct
When pricing a forward on a stock that pays dividends, each expected payment is individually discounted to its present value. The sum of these values is deducted from the current stock price to reflect the lost income for the forward buyer. Finally, the resulting amount is compounded to the expiration date to determine the fair and arbitrage-free forward price.

48. (B) A "fair" price is chosen such that neither party has an initial asset or liability.
A forward contract is structured so that it has no initial market value, meaning neither party owes the other any money at the time of signing. This is achieved by selecting a forward price that perfectly balances the current spot price and the cost of carry. This fair pricing mechanism ensures that the contract begins as a neutral obligation.

49. (A) ₹ 507.54
The theoretical forward price is determined by compounding the current spot price using the specified interest rate and frequency. For an asset with monthly compounding over three months, the spot price is adjusted upward to reflect the interest that could have been earned. This result represents the equilibrium price where no arbitrage opportunities exist between the spot and forward markets.

50. (C) It must result in the contract having zero value and prohibit arbitrage.
At the moment a forward contract is created, the forward price must be established such that the contract's value is zero. This equilibrium ensures that the agreement is fair to both the long and short positions without requiring an upfront cash exchange. Furthermore, this specific price prevents market participants from exploiting risk-free profit opportunities through market arbitrage.

51. (A) (I), (II), (III), and (V)
Forward Rate Agreements involve a notional principal that is used only for calculation and is never exchanged. The buyer pays a fixed rate while the seller pays a floating rate, with the difference being settled in cash. These contracts are settled on a single date without interim flows, making them efficient tools for managing future interest rate exposures and risks.

52. (D) ₹ 1,00,000
At the expiration of a forward contract, its value is the difference between the current market price of the asset and the agreed-upon forward price. Since the buyer is able to purchase the car for a price significantly lower than its current market worth, the contract holds positive value. This gain represents the financial benefit realized by locking in the lower price.

53. (A) (I) and (II) only
The value of a forward position during its life is determined by the difference between the spot price and the discounted forward price. For a long position, this value increases as the spot price rises, while for a short position, the value is simply the negative of the long's value. These mathematical expressions are fundamental for the mark-to-market valuation of derivatives.

54. (C) A higher dividend yield will mathematically increase the forward price of a stock.
In the cost-of-carry model, any income generated by an asset acts as a benefit that

NODIA

Oct/Nov 2005

27. Which of the following represents the most appropriate definition of "contango"?

(A) When the futures price is above the expected future spot price, resulting in an upward sloping forward curve.

(B) When the futures contracts are trading at a discount to the spot price due to high convenience yields.

(C) When the initial margin required by the broker exceeds the variation margin due to market volatility.

(D) When the forward curve becomes backwarded in physically delivered contracts to keep a production process running.

May/June 2020

28. How does a party holding a futures contract reduce losses if the asset price moves against them?

(A) Entering an opposite market position to offset the original trade and exit the contract before its maturity.

(B) Withholding the required daily variation margin payments until the contract reaches its final expiration date.

(C) Negotiating the contract's delivery price with the clearinghouse members to reflect new market valuations.

(D) Changing the standardized features of the futures agreement to delay physical delivery to a much later date.

Oct/Nov 2015

29. All of the following are mechanisms developed by futures exchanges to eliminate non-compliance with contractual obligations, EXCEPT:

(A) The formal creation and maintenance of a central clearinghouse entity.

(B) The mandatory institution of initial and variation margin requirements.

(C) Allowing parties to customize delivery dates and contract sizes privately.

(D) The daily marking-to-market of all individual futures trading accounts.

May/June 2013

30. Which of the following statements accurately represents the concept of normal backwardation?

(A) The futures price is above the expected future spot price, resulting in an upward sloping forward curve.

(B) The futures price does not converge with the spot price at maturity, allowing for easy arbitrage.

(C) The convenience yield is extremely low because warehouse stocks are exceptionally high.

(D) The futures price is below the expected future spot price, often due to the benefits of owning the physical material.

Oct/Nov 2021

31. Identify the correctly matched pair regarding interest rate futures.

(A) Long position profit — When the actual price of the future contract falls.

(B) Short position profit — When the actual price of the future contract rises.

(C) Expectation of interest rate falling — Take a long future position.

(D) Expectation of interest rate rising — Take a long future position.

May/June 2024

32. Consider the following statements regarding the differences between Futures and Forward Contracts:

I Futures contracts are highly regulated, whereas forward markets lack such national-level regulation.

II Forward contracts provide more liquidity because they do not require standardized features.

III Futures exchanges have mechanisms to eliminate non-compliance, unlike forward contracts.

IV In a futures contract, losing parties can easily offset their position to reduce losses.

V Futures prices of nearby expiring contracts are often used as proxies for spot prices in decentralized markets.

Which combination of statements is correct?

(A) (I), (II), (III), and (IV)

(B) (I), (III), (IV), and (V)

(C) (II), (III), (IV), and (V)

(D) (I), (II), (IV), and (V)

Oct/Nov 2008

33. Match the hedging expectations in List I with their corresponding strategies in List II.

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64. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The buyer of a Forward Rate Agreement is effectively locking in a fixed borrowing cost. If the market interest rate at the time of settlement is higher than the agreed contract rate, the buyer has successfully avoided a higher expense. To compensate for this, the seller pays the buyer the difference between the two rates, based on the notional amount.

65. (A) P-4, Q-3, R-2, S-1
Various terms describe the components and mechanics of a Forward Rate Agreement. The notional amount provides the basis for interest calculations, while the reference rate serves as the benchmark for comparison. The settlement amount represents the actual cash flow exchanged between parties, and the contract period defines the duration of the underlying interest rate exposure being managed.

66. (D) The buyer of an FRA borrows at the FRA rate, effectively paying fixed and receiving floating.
In a Forward Rate Agreement, the buyer takes a position that benefits from rising interest rates. This is achieved by agreeing to pay a fixed interest rate while receiving a floating reference rate. This structure effectively allows the buyer to hedge against the risk of increasing costs on a future loan or to speculate on an upward trend in rates.

67. (D) The interest differential is paid upfront on the settlement date, discounted using the settlement rate.
The settlement of a Forward Rate Agreement occurs at the beginning of the contract period rather than at the end. Because the interest differential represents a value that would normally be realized at maturity, it is discounted back to the settlement date. This present-value payment ensures that the timing of the cash flow is accurately accounted for in the transaction.

68. (A) FRAs are marked-to-market daily and require the posting of daily collateral.
Forward Rate Agreements are over-the-counter instruments that typically do not involve a central clearinghouse or daily marking-to-market. Unlike exchange-traded futures, they do not require participants to post daily margin or collateral based on price fluctuations. Instead, the final settlement is determined once on the fixing date and paid on the settlement date, leaving counterparties exposed to credit risk.

69. (B) Eliminating counterparty risk entirely through the use of a clearinghouse.
Forward Rate Agreements are primarily traded in the over-the-counter market, which means they are private contracts between two parties. Unlike standardized exchange-traded derivatives, there is no central clearinghouse to guarantee the performance of the contract. Consequently, participants must carefully assess and accept the credit risk of their counterparties, as no third-party guarantee exists to eliminate default potential.

70. (B) Alpha Ltd pays the interest differential to ABC Bank because the contract rate is higher than the settlement rate.
In this specific interest rate agreement, the buyer committed to paying a fixed rate of eight percent. Since the actual market reference rate turned out to be only seven percent, the buyer is obligated to pay the difference to the seller. This outcome occurs because the buyer's locked-in rate is higher than the prevailing market rate at settlement.

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36. (A) An OTC contract to exchange interest payments for a notional principal on a settlement date.
A Forward Rate Agreement is a specialized over-the-counter derivative used to manage interest rate exposure. In this contract, two parties agree to exchange the difference between a fixed interest rate and a floating market reference rate at a future date. The calculation is based on a notional principal amount that is never actually exchanged between the participants during settlement.

37. (A) (I) and (III) only
Holding an asset involves both expenses, such as storage and insurance, and benefits, such as dividends or interest. The net difference between these factors is known as the cost of carry. Furthermore, the opportunity cost of the funds used to purchase the asset is represented by compounding the initial price at the risk-free rate over the specified holding period.

38. (D) $F = S_t e^{r(T-t)}$
When interest is assumed to compound continuously, the theoretical price of a forward contract is derived using an exponential function. This formula multiplies the current spot price of the underlying asset by the mathematical constant e raised to the power of the risk-free interest rate and the time remaining until expiration. It represents the standard model for financial pricing.

39. (B) (I) and (III) only
Assets like coupon-paying bonds or dividend-distributing stocks generate cash flows that benefit the owner of the physical asset. Since the buyer of a forward contract does not receive these interim payments, the theoretical forward price must be reduced by the present value of the expected income. This adjustment ensures that the forward price remains fair and arbitrage-free for both parties.

40. (B) (I), (II), (IV), and (V)
After a forward contract is initiated, its financial value fluctuates based on several market variables. These key determinants include the current price of the underlying asset, the originally agreed forward price, the prevailing risk-free interest rate, and the remaining time until the contract reaches maturity. Credit ratings influence risk but are not standard variables in the mathematical valuation formula.

41. (B) An FRA having a 3-month waiting period and a 3-month contract period.
In the notation used for Forward Rate Agreements, the first number indicates the time until the contract begins, and the second number represents the total time until the contract ends. Therefore, a three-by-six agreement implies that the settlement occurs in three months and the interest period covered by the contract lasts for an additional three-month period until maturity.

42. (C) The forward price is adjusted daily to ensure the forward value remains zero.
While the market value of a forward contract changes every day as asset prices and interest rates fluctuate, the forward price itself is fixed at the time of initiation. It does not adjust periodically to reset the contract's value to zero. This lack of daily marking-to-market is a fundamental characteristic that distinguishes forwards from exchange-traded futures contracts.

43. (B) ₹ 11.50
The value of a long forward position is found by taking the current asset price and subtracting the present value of the agreed forward price. Using continuous discounting over the remaining term at the risk-free rate, the future obligation is converted to its current worth. In this instance, the positive result indicates that the contract has become a financial asset.

44. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
At the start of a forward contract, the agreed price is set such that the net present value is exactly zero for both participants. This ensures that no initial payment is required from either the buyer or the seller. Because the contract is designed to be fair at the outset, neither party begins the agreement with an immediate liability.

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account with the gain or loss made.
(C) The exchange converts the futures contract into a forward contract to allow for private negotiation.
(D) The variation margin is temporarily lowered to accommodate the trader's financial situation.

Oct/Nov 2022

7. What is a futures contract?
(A) A customized over-the-counter agreement between private parties to exchange cash and specific assets on maturity.
(B) A standardized exchange-traded contract to buy or sell assets at a future date with daily settlement of gains.
(C) A fixed, non-negotiable legal contract requiring parties to fulfill specific delivery duties despite market changes.
(D) An unstandardized, private forward agreement negotiated directly between market participants without any central oversight.

May/June 2021

8. Which of the following statements is true regarding the delivery process in futures contracts?
(A) The vast majority of futures contracts lead to the physical delivery of the underlying asset.
(B) The party with the short position determines the exact delivery time and the place of delivery.
(C) The exchange randomly chooses a party holding a short position to take delivery from a long position.
(D) The exact delivery time during the delivery period is determined by the party with the long position.

Oct/Nov 2009

9. Standardization of a futures contract includes all of the following areas EXCEPT:
(A) Contract size.
(B) Creditworthiness of the counterparty.
(C) Delivery arrangements and months.
(D) Price quotes and price limits.

May/June 2007

10. Why do futures contracts provide greater liquidity compared to forward contracts?
(A) They are non-negotiable and require middlemen to bring in counterparties.
(B) They are tailor-made to suit the specific needs of the parties regarding contract size and delivery.
(C) They are standardized and negotiable, allowing them to be easily traded on organized exchanges.
(D) They involve exchange of assets and cash only on the maturity date without daily settlement.

Oct/Nov 2011

11. Arrange the general steps involved in the implementation of future hedges in the correct sequence:
1. Determine whether a long or short future position is appropriate to reduce the risk.
2. Select the best future contract for each cash position.
3. Identify the risk exposure involved in a banking transaction which needs to be reduced.
4. Implement the hedge by buying or selling future contracts.
5. Determine the appropriate number of future contracts to buy or sell.

(A) 3, 2, 1, 5, 4
(B) 3, 1, 2, 5, 4
(C) 1, 3, 2, 4, 5
(D) 3, 1, 5, 2, 4

May/June 2012

12. Which body regulates the futures market in India to protect investors' interest in the stock market?
(A) Reserve Bank of India (RBI)
(B) Ministry of Finance
(C) Securities and Exchange Board of India (SEBI)
(D) Clearing Corporation of India Limited (CCIL)

Oct/Nov 2025

13. Which of the following statements about the margin account is incorrect?
(A) If the additional money for a margin call is not provided, the broker must wait until the contract's expiry date to close out the trader's position.
(B) If the margin account balance falls below the variation margin, the trader receives a

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margin call to provide additional funds.
(C) The amount of money to be provided upon receiving a margin call is equal to the difference between the initial margin and the current margin account balance.
(D) A trader has the option to withdraw excess amounts whenever the margin account balance shows an amount higher than the initial margin.

May/June 2023

14. Which of the following statements correctly describes the calculation of the settlement price in an exchange?
(A) It is the exact price of the last traded contract before the exchange closes.
(B) It is always based on the theoretical price of the underlying asset in the spot market, regardless of trading volume.
(C) It is calculated on the basis of the last half an hour weighted average price.
(D) It is the average of the highest and lowest prices traded throughout the entire day.

Oct/Nov 2018

15. In the context of hedging with interest rate futures, what is the most appropriate reason a trader with a short position profits when interest rates rise?
(A) Higher interest rates cause current bond prices to increase, which directly enhances the value of the short position.
(B) The derivative contracts grant them the legal right to purchase underlying securities at a discount in the spot market.
(C) The central clearinghouse pays out a specific cash premium to short sellers during periods of aggressive tightening.
(D) Rising rates lower bond prices, and the short position allows selling the underlying asset at the previous higher price.

May/June 2005

16. What is a clearinghouse in the context of futures trading?
(A) A central intermediary acting as a performance guarantor for both the buyers and the sellers in every transaction.
(B) A decentralized physical marketplace for the immediate buying and selling of various underlying raw commodities.
(C) A federal regulatory organization that reviews and approves new derivative products and standard trading rules.
(D) A professional market broker responsible for maintaining margin accounts and adjusting them to daily prices.

Oct/Nov 2016

17. A hedger implementing a future hedge involves several steps. Which of the following is NOT one of those steps?
(A) Ensuring the future contract chosen has a low correlation with the cash rate to maximize diversification.
(B) Identifying the risk exposure involved in a banking transaction.
(C) Determining the appropriate number of future contracts to buy or sell.
(D) Determining when to get out of the hedge position either by reversing the trade or letting the contract expire.

NODIA

May/June 2015

18. Which of the following bodies is responsible for calculating the conversion factor for eligible securities that can be delivered in an interest rate futures contract?
(A) National Stock Exchange (NSE)
(B) Securities and Exchange Board of India (SEBI)
(C) Reserve Bank of India (RBI)
(D) The Clearing House

Oct/Nov 2007

19. Which of the following statements regarding interest rate futures is incorrect?
(A) Exchanges offer products including 6-year, 10-year, and 13-year Government of India (GOI) Securities.
(B) Exchanges offer 91-day Government of India Treasury Bill Futures.
(C) A person holding a short position in a 6-year GOI securities futures contract can deliver eligible securities with a maturity between 4-8 years.
(D) Delivery of underlying securities is compulsory for all traders holding interest rate futures at the end of the trading day.

May/June 2025

20. Which of the following statements correctly identifies the action of a portfolio manager expecting a decrease in the interest rate?

(A) Entering a long position in futures to increase portfolio value by capitalizing on rising bond prices.
(B) Selling various longer duration bonds and buying shorter ones to decrease the overall sensitivity of the fund.
(C) Entering a short position in the futures market to effectively reduce the modified duration of the portfolio.
(D) Maintaining high variation margins in the trading account to protect against anticipated drops in bond prices.

Oct/Nov 2019

21. Arrange the following steps of margin account operation in the correct chronological order:
1. Debit any loss from the margin account or credit any gain to it.
2. If the balance drops below the variation margin, issue a margin call.
3. On the day the contract is entered into, credit the account with the initial margin amount.
4. On a daily basis, compute gains and losses on the futures contracts.

(A) 3, 4, 1, 2
(B) 3, 1, 4, 2
(C) 4, 1, 3, 2
(D) 3, 2, 4, 1

May/June 2009

22. In which year were interest rate futures first introduced in the National Stock Exchange (NSE)?
(A) 1975
(B) 2003
(C) 2013
(D) 2014

Oct/Nov 2010

23. In a short hedging strategy involving interest rate futures, why does a bank sell future contracts?
(A) The bank predicts falling interest rates will increase bond prices, allowing them to offset losses in the cash market.
(B) The bank seeks to fix a high current yield for anticipated future investments when additional funds are available.
(C) The bank intends to acquire delivery of specific underlying securities at significantly lower prices in the future.
(D) The bank anticipates rising interest rates will lower bond prices, increasing the value of their short position.

May/June 2011

24. When utilizing futures to change the duration of a portfolio, a manager needs to determine all of the following EXCEPT:
(A) The overall acceptable level of change in the total value of the current portfolio.
(B) The specific desired duration based on the acceptable level of change in the portfolio.
(C) The total number of futures contracts that should be bought or sold to meet targets.
(D) Determining the exact physical location where the bonds will be delivered upon expiration.

Oct/Nov 2024

25. Identify the incorrect statement regarding the differences between forward contracts and futures contracts.
(A) Forward contracts are not negotiable, meaning both parties must fulfill their obligations even if situations change.
(B) Forward markets are far more transparent than futures markets because their prices and volume are widely reported.
(C) Futures contracts are highly standardized, which reduces their flexibility compared to forward contracts.
(D) Futures contracts are easier and cheaper to trade than forward contracts because they do not require middlemen to find counterparties.

May/June 2017

26. What is the definition of "marking-to-market" in futures trading?
(A) The process of randomly choosing a party that holds a long position to take delivery.
(B) The method used to determine the exact delivery time during the delivery period by the short position.
(C) The conversion of a forward contract into a negotiable futures contract on an exchange.
(D) The process of updating the margin account daily based on the daily settlement price of the contract.

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reduces the net cost of holding that asset. Therefore, as the dividend yield of a stock increases, the theoretical forward price must decrease accordingly. Claiming that a higher dividend yield increases the forward price is a contradiction of basic financial derivative pricing principles.

55. (A) Forward contracts delay payment, meaning the investor does not forego interest until expiration.
The forward price is higher than the spot price because the buyer of a forward contract delays payment until a future date. During this interval, the buyer retains their funds and can earn interest, which represents an advantage. To maintain market equilibrium and fairness, the forward price must be compounded to include this interest or opportunity cost of capital.

56. (A) Price is the agreed transaction amount, while value is the worth of the position.
In derivative terminology, the price refers to the specific transaction amount agreed upon by the counterparties for the future trade. In contrast, the value represents the current monetary worth of the contractual position as market conditions change. While the price is fixed at inception, the value fluctuates over time, reflecting potential profits or losses for the participants involved.

57. (A) ₹ 1163.40
To find the forward price of a coupon-bearing bond, one must first subtract the present value of all expected coupon payments from the current market price. This net amount is then compounded using the risk-free rate for the duration of the contract. This calculation ensures that the forward price correctly reflects the exclusion of interim interest payments for the buyer.

58. (A) -₹ 65.15
The value of a long forward position is calculated by subtracting the present value of the forward price from the current spot price. When the asset's market price is significantly lower than the discounted contract price, the value becomes negative. This indicates that the holder of the long position is currently facing an unrealized loss on their commitment to buy.

59. (C) Investment with known income I (discrete compounding): $F = (S_t - I)(1 + r)^{(T-t)}$
The standard formula for pricing a forward contract on an asset with a known discrete income involves subtracting the present value of that income from the spot price. The resulting figure is then compounded at the risk-free rate to the expiration date. This specific model accurately captures the impact of periodic cash flows on the equilibrium price of the derivative.

NODIA

60. (B) (I), (II), and (IV) only
Following the start of a forward agreement, the contract's value fluctuates, becoming either an asset or a liability for each party. Because these contracts are zero-sum games, the positive value held by one counterparty must be perfectly balanced by an equal negative value for the other. Consequently, the sum of the long and short values always equals zero.

61. (D) (I), (II), (III), and (IV)
Forward Rate Agreements are versatile financial tools used for various purposes. They allow borrowers to lock in interest rates to hedge against increases and lenders to protect against decreases. Additionally, traders utilize them to speculate on future rate movements, while arbitrageurs use them to exploit price discrepancies between different interest rate instruments in the financial market.

62. (A) Contract rate – The interest rate the two contracting parties negotiate on trade date.
In a Forward Rate Agreement, the contract rate is the fixed interest rate determined at the start of the agreement. This rate is compared against a floating reference rate on the fixing date to calculate the settlement amount. Understanding the specific timing of rate negotiation and the definitions of the various dates is crucial for identifying the roles of each counterparty.

63. (B) (III), (II), (I), (IV)
The chronological progression of a Forward Rate Agreement begins with the trade date, where terms are agreed upon. Next is the fixing date, when the reference interest rate is determined. This is followed by the settlement date, where the cash difference is paid. Finally, the maturity date marks the end of the notional loan period defined in the contract.

List I: (Hedging Expectations)
P. Expecting interest rate to rise
Q. Expecting interest rate to fall
R. Expecting bond price to fall
S. Expecting bond price to rise
List II: (Strategies)
1. Long future position
2. Short future position
3. Sell future contracts
4. Buy future contracts
(A) P-2, Q-1, R-3, S-4
(B) P-1, Q-2, R-4, S-3
(C) P-3, Q-4, R-1, S-2
(D) P-4, Q-3, R-2, S-1

May/June 2006

34. Select the correct answer for the following assertion and reason statements.
Assertion (A): Physically delivered futures contracts may exhibit contango where the futures price is above the expected future spot price.
Reason (R): Contango is fundamentally caused by a high convenience yield which implies a high return on warehouse inventory.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2017

35. Consider the following statements about the relationship between spot price and future price:
I The futures price converges to the spot price at expiration because the short delivers the actual asset and the long pays the current spot price.
II In cash settlement contracts, automatic convergence is ensured by formally setting the futures price to the spot price at the final mark to market.
Which of the statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2008

36. A trader holds a margin account that reached a balance of ₹ 80,000 following a price increase to ₹ 6,100 per ton on 20 rice futures (contract size 10 tons). On the second day, the price comes down from ₹ 6,100 to ₹ 5,950 a ton. What is the loss incurred on this day, and what will be the final balance in the margin account?
(A) Loss of ₹ 15,000; Balance ₹ 65,000
(B) Loss of ₹ 30,000; Balance ₹ 50,000
(C) Loss of ₹ 30,000; Balance ₹ 30,000
(D) Loss of ₹ 10,000; Balance ₹ 70,000

Oct/Nov 2013

37. Match the terms in List I with their descriptions in List II.
List I: (Terms)
P. Initial Margin
Q. Variation Margin
R. Margin Call
S. Marking-to-market
List II: (Descriptions)
1. The process of updating the account daily based on the settlement price.
2. A demand to provide additional funds when the account balance decreases below a certain level.
3. The amount credited to the account on the day the contract is entered into.
4. The minimum amount that should be available in the account at all times.
(A) P-3, Q-4, R-2, S-1
(B) P-4, Q-3, R-1, S-2
(C) P-3, Q-1, R-4, S-2
(D) P-2, Q-4, R-3, S-1

May/June 2015

38. Consider the following statements about margin account operation:
I As long as the balance is above the variation margin amount, the trader does not need to do anything.
II When the balance drops below the variation margin, the trader receives a margin call.
III Additional funds provided must bring the balance exactly back to the variation margin amount.

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I The value of the futures is solely based on the cost of the carry model without any influence from demand and supply.
II A holistic view is taken to price future contracts, normally equating the price to the monetary value of risk.
III A buyer of a contract will buy only if their risk is shielded.

Which combination of statements is correct?
(A) (I) and (II)
(B) (I) and (III)
(C) (II) and (III)
(D) (I), (II), and (III)

Oct/Nov 2014

51. A bank expects the interest rate to rise and the bond price to fall. To hedge the risk, it decides to sell 10 lots of interest rate futures (5.5% GOI 2031) at a Future Price of ₹ 103.00. Each lot is equal to 2000 units. The margin requirement is 2.5%. What is the total value of the futures contract initiated?
(A) ₹ 2,06,000
(B) ₹ 5,15,000
(C) ₹ 20,60,000
(D) ₹ 51,50,000

May/June 2019

52. Identify the correctly matched pair regarding the pricing and delivery of futures.
(A) Cost of carry model — Used to calculate the price of both forward and futures contracts.
(B) Convenience yield — Directly proportional to warehouse inventory levels.
(C) Cash settlement — Involves the physical transfer of the underlying stock index.
(D) Delivery period — Exclusively decided by the buyer (long position) in the contract.

Oct/Nov 2006

53. Consider the following statements regarding cash settlement in futures contracts:
I In contracts such as stock index futures, the contract is marked to market at the end of the last trading day and all positions are declared closed.
II The margin account balance at the end of the last trading day represents the final physical delivery of the underlying asset.

Which of the statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

May/June 2021

54. Select the correct answer for the following assertion and reason statements.
Assertion (A): A margin call is issued to a trader when their margin account balance shows an amount higher than the initial margin.
Reason (R): Traders are generally permitted to withdraw funds from their margin account that exceed the initial margin requirement.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2010

55. Consider the following statements regarding hedging with interest rate futures:
I Hedging involves associating each future position with a cash position to reduce risk.
II Cash and future rates on similar underlying instruments generally move in opposite directions.
III Choosing the right contract means selecting one where the correlation between the cash rate and future rates is high.
IV Taking a short position in interest rate futures profits when interest rates rise.

Which combination of statements is correct?
(A) (I), (II), and (III)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), and (IV)

NODIA

May/June 2005

56. Match the Exchange/Product features in List I with their specifications in List II.
List I: (Exchange/Product features)
P. Bond Futures underlying
Q. Specific product offering
R. Lot size of interest rate futures

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III The exchange randomly chooses a counterparty holding the opposite position to fulfill the delivery.

Which combination of statements is correct?

(A) (I), (II) and (III)
(B) (I) and (III)
(C) (II) and (III)
(D) (I), (II), and (III)

Oct/Nov 2009

45. A trader enters a futures contract to buy 20 futures of rice through a clearinghouse member at a price of ₹ 6,000 a ton. The contract size is 10 tons per future. The margin requirement is 5%. Suppose the next day the futures price increases from ₹ 6,000 to ₹ 6,100 a ton. What will be the new balance in the margin account after marking-to-market?

(A) ₹ 60,000
(B) ₹ 70,000
(C) ₹ 80,000
(D) ₹ 1,00,000

May/June 2023

46. Match the market scenarios in List I with their corresponding curve characteristics in List II.

List I: (Market Scenarios)

P. Contango
Q. Normal backwardation
R. High warehouse stocks
S. Low warehouse stocks

List II: (Curve Characteristics)

1. Low convenience yield.
2. High convenience yield.
3. Upward sloping forward curve.
4. Futures price is below expected future spot price.

(A) P-4, Q-3, R-2, S-1
(B) P-3, Q-4, R-1, S-2
(C) P-3, Q-4, R-2, S-1
(D) P-1, Q-2, R-3, S-4

Oct/Nov 2018

47. Select the correct answer for the following assertion and reason statements.

Assertion (A): Forward contracts are subject to default and require careful consideration of the credit quality of the counterparties.

Reason (R): In a forward contract, the entire payoff is made at expiration, meaning a loss by one party can be large enough to trigger a default.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2007

48. Identify the incorrectly matched pair regarding the margin account operations.

(A) Additional funds provided — Equal to initial margin amount minus balance in the margin account.
(B) Margin call triggered — When the margin account balance falls below the initial margin amount.
(C) Excess margin — Can be withdrawn if the balance shows an amount higher than the initial margin.
(D) Unwinding position — Broker's right if the requested additional money is not provided.

Oct/Nov 2025

49. Consider the following statements about portfolio duration management using futures:

I When interest rates rise, long-term bonds decrease in value more than short-term bonds.
II Reducing the duration of a portfolio makes it more price-sensitive.
III Taking a short position in futures can reduce the duration of the portfolio.
IV Selling longer duration bonds and buying shorter duration bonds involves high transaction costs compared to futures.
V To increase portfolio value when expecting a decrease in interest rates, a manager should take a long position in futures.

Which combination of statements is correct?

(A) (I), (III), (IV), and (V)
(B) (I), (II), (III), and (IV)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (IV), and (V)

May/June 2012

50. Consider the following statements regarding the pricing of future contracts:

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16. (A) A central intermediary acting as a performance guarantor for both the buyers and the sellers in every transaction.
A clearinghouse acts as a central counterparty for every transaction executed on a futures exchange. By becoming the seller to every buyer and the buyer to every seller, it effectively eliminates individual counterparty credit risk. The clearinghouse ensures contract performance through margin requirements and daily settlements, providing a guarantee that both sides of the trade will be honored as agreed.

17. (A) Ensuring the future contract chosen has a low correlation with the cash rate to maximize diversification.
Effective hedging requires selecting a futures contract that moves in close synchronization with the underlying cash position. A high positive correlation between the cash rate and the futures price ensures that gains in the futures market accurately offset losses in the cash market. Therefore, choosing a contract with low correlation would be counterproductive to the primary goal of risk mitigation.

18. (A) National Stock Exchange (NSE)
The National Stock Exchange is responsible for publishing technical parameters required for the settlement of interest rate futures. This includes calculating conversion factors for various Government of India securities that are eligible for delivery against a contract. These factors adjust for the differences in coupon rates and maturities of the bonds actually delivered versus the notional bond used in trading.

19. (D) Delivery of underlying securities is compulsory for all traders holding interest rate futures at the end of the trading day.
Interest rate futures traded on Indian exchanges include various tenors like Treasury bills and longer-term government securities. While these contracts are legally binding, most traders do not intend to take or make physical delivery. Instead, they typically close out or square off their positions before the contract matures, settling their gains or losses in cash through the exchange marking-to-market process.

20. (A) Entering a long position in futures to increase portfolio value by capitalizing on rising bond prices.
Bond prices and interest rates share an inverse relationship. When a portfolio manager expects interest rates to decrease, they anticipate that bond prices will rise. By entering a long position in interest rate futures, the manager can profit from this expected price appreciation. This strategy allows the portfolio to benefit from falling rates without the need to immediately purchase physical bonds.

21. (A) 3, 4, 1, 2
Margin account operations follow a strict daily cycle to maintain market integrity. Initially, the trader deposits the required initial margin. At the end of each trading day, the exchange computes gains and losses based on the settlement price. These amounts are then credited or debited to the account. If the balance falls below a threshold, a call is issued.

22. (B) 2003
Interest rate futures were first introduced on the National Stock Exchange of India in June 2003. This initial launch aimed to provide market participants with tools to manage interest rate risk. Although the market underwent various structural changes and product re-launches in later years, this date marks the formal beginning of interest rate derivatives trading on organized Indian exchanges.

23. (D) The bank anticipates rising interest rates will lower bond prices, increasing the value of their short position.
A short hedge is used to protect against the risk of falling asset prices. In a banking context, if interest rates are expected to rise, the market value of bonds will decrease. By selling interest rate futures, the bank creates a position that gains value as prices fall, thereby offsetting the loss in the market value of its physical bond portfolio.

24. (D) Determining the exact physical location where the bonds will be delivered upon expiration.
Managing portfolio duration with futures involves calculating the current sensitivity and the target sensitivity to interest rate

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S. Notional bond face value of one lot

List II: (Specifications)

1. 2000 bonds
2. ₹ 2,00,000
3. 91-day GOI Treasury Bill Futures
4. 4-8 years residual maturity GOI securities

(A) P-4, Q-3, R-1, S-2
(B) P-3, Q-4, R-2, S-1
(C) P-1, Q-2, R-3, S-4
(D) P-4, Q-1, R-3, S-2

Oct/Nov 2022

57. A trader enters a futures contract to buy 20 futures of rice through a clearinghouse member at a price of ₹ 6,000 a ton. The contract size is 10 tons per future. The margin requirement for the rice contract is 5%. What is the initial margin amount the Clearing Member needs to post for this transaction?
(A) ₹ 30,000
(B) ₹ 60,000
(C) ₹ 1,20,000
(D) ₹ 12,00,000

May/June 2018

58. Consider the following statements about the clearinghouse:
I The clearinghouse will keep track of all transactions that take place during the day to calculate the net positions of each clearing member.
II The clearinghouse maintains a single consolidated margin account for all its clearing members combined.
Which of the statements is/are correct?
(A) Only (I)
(B) Only (II)
(C) Both (I) and (II)
(D) Neither (I) nor (II)

Oct/Nov 2016

59. Consider the following statements about the clearinghouse and margin accounts:
I The clearinghouse acts as an intermediary in all futures transactions.
II Every trader maintains a margin account directly with the clearinghouse.
III The variation margin is also known as the maintenance margin.
IV The clearing margin is the percentage of contract value provided by the Clearing Member to the clearinghouse.
V Marking-to-market credits gains and debits losses on a daily basis.
Which combination of statements is correct?
(A) (I), (III), (IV), and (V)
(B) (I), (II), (III), and (IV)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (IV), and (V)

May/June 2014

60. Consider the following statements regarding contango and backwardation:
I Contango occurs when an asset price is expected to rise over time, resulting in an upward sloping forward curve.
II Normal backwardation happens when the futures price is above the expected future spot price.
III Physically delivered futures contracts may be in contango due to fundamental factors like storage and financing.
Which combination of statements is correct?
(A) (I) and (II)
(B) (I) and (III)
(C) (II) and (III)
(D) (I), (II), and (III)

Oct/Nov 2007

61. A bank's portfolio has an initial duration D = 8.2 and a targeted duration DT = 3.09. The bank plans to use futures with a duration DCTD = 7.3 and price PCTD = 98.45. Each lot has a face value of ₹ 2,00,00,000 equivalent to 2000 units. The portfolio target is valued at PT = 2,00,00,000.
Based on the formula (DT - D) × [PT / (DCTD × PCTD)], where PCTD in the denominator is the price of the futures contract per lot, how many futures contracts should the manager short?
(A) 36 contracts
(B) 54 contracts
(C) 72 contracts
(D) 88 contracts

May/June 2025

62. A banker bought 10 lots of futures (lot size 2000) at ₹ 92.59. On a later date, the price rises to ₹ 93.07 with a yield of 6.45%. The banker squares off the position at the current market price. What is the total value of the position when sold?
(A) ₹ 18,51,800

ANSWERS

1. (B) 2000 bonds with a notional face value of ₹ 2,00,000
In the Indian financial markets, interest rate futures are standardized contracts used for hedging and speculation. Each trading lot for these futures consists of exactly two thousand bonds. Each bond carries a notional face value of one hundred rupees. Consequently, the total notional face value for one single lot is calculated as two lakh rupees, ensuring standardized trading sizes.

2. (C) The method of determination of futures prices is fundamentally different from that used for forward contracts.
Both futures and forward contracts typically utilize the cost of carry model for price determination. This model incorporates the spot price of the underlying asset plus the costs of financing and storage, minus any income generated. Therefore, the fundamental valuation principles remain consistent across both instruments, despite differences in exchange trading, daily settlement, and contract standardization.

3. (C) The implied return on warehouse inventory derived from holding physical material to keep production processes running.
Convenience yield represents the non-monetary benefit or return associated with holding physical inventory rather than a derivative contract. It arises when physical stocks are low, making the material valuable for maintaining production processes without interruption. High convenience yields often lead to backwardation, where the spot price exceeds the futures price, reflecting the immediate utility of the physical asset.

4. (C) Market efficiency and arbitrage ensure the price reflects that the short delivers assets while the long pays spot.
As a futures contract approaches its expiration date, the futures price must align with the spot price of the underlying asset. This convergence is driven by arbitrageurs who would exploit any significant price differences between the two markets. At maturity, the contract is essentially an agreement for immediate delivery, making the futures and spot prices mathematically identical for participants.

5. (B) By settling gains and losses on a daily basis, which significantly reduces the potential default exposure.
Clearinghouses mitigate credit risk by implementing a daily settlement process known as marking-to-market. Instead of allowing losses to accumulate until the contract expires, the exchange calculates gains and losses at the end of every trading session. These amounts are then immediately adjusted in the participants' margin accounts, preventing the buildup of large, unmanageable default exposures across the exchange.

6. (B) The broker has the right to close out the trader's position and update the margin account with the gain or loss made.
Brokers enforce strict margin requirements to ensure financial stability in the derivatives market. If a trader's account balance falls below the maintenance level and they fail to replenish it, the broker is authorized to liquidate the position. This immediate square-off prevents further losses and ensures that the existing deficit can be covered by the remaining balance in the account.

7. (B) A standardized exchange-traded contract to buy or sell assets at a future date with daily settlement of gains.
A futures contract is a highly standardized financial agreement traded on organized exchanges. Unlike forward contracts, futures involve fixed sizes, delivery dates, and quality specifications, making them easily tradable. The central clearinghouse guarantees performance for both parties, and gains or losses are settled daily through marking-to-market, which eliminates the accumulation of significant counterparty credit risk over time.

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(B) The party with the short position
(C) The party with the long position
(D) The broker representing the long position

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IV If additional funds are not provided, the broker has the right to unwind the original position.

Which combination of statements is correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

Oct/Nov 2012

39. Select the correct answer for the following assertion and reason statements.

Assertion (A): The futures price must move or converge toward the spot price as the contract approaches maturity.

Reason (R): If they do not converge on maturity, the presence of arbitrage opportunities allows traders to make risk-free money.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2011

40. Identify the incorrectly matched pair regarding futures market concepts.

(A) Closing out a position — Entering into the opposite trade to the original one.
(B) Mark-to-market — Process used to price futures contracts at the end of every trading day.
(C) Offset — A long selling her previously opened contract or a short buying her previously opened contract.
(D) Settlement price — Always the price of the very first trade executed at the opening of the exchange.

Oct/Nov 2020

41. A bank sold 10 lots of interest rate futures (lot size 2000) at ₹ 103.00. Later, the bank squares off the position when the Future Price drops to ₹ 98.10. What is the total value of the square-off position when the bank buys the futures back?

(A) ₹ 19,62,000
(B) ₹ 20,60,000
(C) ₹ 18,50,000
(D) ₹ 19,81,000

May/June 2022

42. Match the comparative features of Forwards and Futures in List I with their status in List II.

List I: (Features)
P. Standardization in Futures
Q. Negotiability in Forwards
R. Liquidity in Futures
S. Performance risk in Futures

List II: (Status)
1. Higher due to organized exchanges.
2. Not present, parties must fulfill obligations.
3. Eliminated through clearinghouse mechanism.
4. Reduces flexibility compared to tailor-made contracts.

(A) P-1, Q-2, R-4, S-3
(B) P-4, Q-2, R-1, S-3
(C) P-4, Q-3, R-1, S-2
(D) P-2, Q-1, R-4, S-3

Oct/Nov 2023

43. Consider the following statements regarding Interest Rate Futures (IRF):

I IRFs were first introduced in the NSE in the year 2003.
II Exchanges must obtain prior regulatory approval before introducing interest rate derivatives.
III The contract value is equal to the quoted price multiplied by 1000.
IV 91-day Government of India Treasury Bill Futures are available on certain exchanges.

Which combination of statements is correct?
(A) (I), (II), and (IV)
(B) (I), (II), and (III)
(C) (II), (III), and (IV)
(D) (I), (III), and (IV)

May/June 2016

44. Consider the following statements regarding delivery in futures contracts:

I Very few futures contracts lead to delivery of the asset because most are closed out before maturity.
II The party with the long position issues the clearinghouse a notice of intention stating the delivery location and grade.

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8. (B) The party with the short position determines the exact delivery time and the place of delivery.
In physically settled futures contracts, the delivery process is governed by specific exchange rules. The party holding the short position, who is the seller, usually has the privilege of initiating the delivery. They decide the exact timing within the specified delivery period and the location among approved sites, while the exchange randomly assigns a long-position counterparty to accept delivery.

9. (B) Creditworthiness of the counterparty.
Standardization is a core feature of futures contracts, ensuring they are fungible and liquid. Exchanges define specific contract sizes, delivery arrangements, months, and price quote limits for all participants. However, the creditworthiness of individual counterparties is not a standardized feature because the central clearinghouse interposes itself as the buyer to every seller and seller to every buyer in the market.

10. (C) They are standardized and negotiable, allowing them to be easily traded on organized exchanges.
High liquidity in futures markets is primarily attributed to the standardization of contract terms and the ability to trade on organized exchanges. Standardized features like contract size and maturity dates allow buyers and sellers to easily enter or exit positions. This negotiability ensures that market participants can quickly offset their obligations without needing to find the original counterparty involved.

11. (B) 3, 1, 2, 5, 4
Implementing a future hedge requires a systematic approach to risk management. Initially, the bank identifies the specific risk exposure needing mitigation. Next, it determines whether a long or short position is suitable. The most appropriate contract is then selected based on correlation. Finally, the bank calculates the required number of lots and executes the trade on the exchange.

12. (C) Securities and Exchange Board of India (SEBI)
The Securities and Exchange Board of India serves as the primary regulatory authority for the stock and derivatives markets. Its core mandate includes protecting investor interests and ensuring market integrity. In the context of interest rate futures, this body oversees exchange operations, sets trading rules, and monitors compliance to maintain a fair and transparent trading environment for all market participants.

13. (A) If the additional money for a margin call is not provided, the broker must wait until the contract's expiry date to close out the trader's position.
Margin accounts are strictly monitored to ensure that all parties can meet their financial obligations. If a trader fails to provide the required funds after a margin call, the broker is not obligated to wait until expiry. Instead, the broker has the right to immediately close out the position to prevent the account deficit from increasing further during market fluctuations.

14. (C) It is calculated on the basis of the last half an hour weighted average price.
The settlement price is a crucial benchmark used for daily marking-to-market and final contract valuation. In most Indian exchanges, this price is not simply the last traded price. Instead, it is calculated as the volume-weighted average price of all trades executed during the final thirty minutes of the trading day, providing a more representative and stable value for settlement.

15. (D) Rising rates lower bond prices, and the short position allows selling the underlying asset at the previous higher price.
When interest rates increase, the market value of existing fixed-income securities like bonds typically decreases. A trader holding a short position in interest rate futures essentially agrees to sell the underlying asset at a predetermined price. As bond prices fall due to rising rates, the short seller profits by buying the asset cheaper than their agreed selling price in the contract.

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(B) ₹ 18,61,400
(C) ₹ 9,30,700
(D) ₹ 19,50,000

Oct/Nov 2019

63. A bank sold 10 lots of interest rate futures (lot size 2000) at a total value of ₹ 20,60,000. It later squared off the position by buying the futures back at a total value of ₹ 19,62,000. What is the net profit or loss realized by the bank from this short hedging strategy?
(A) Loss of ₹ 98,000
(B) Profit of ₹ 98,000
(C) Profit of ₹ 51,500
(D) Loss of ₹ 51,500

May/June 2009

64. Once the clearinghouse receives the notice of intention for physical delivery from the short position, how is the counterparty determined?
(A) The short position holder selects a specific long position holder of their choice.
(B) The exchange matches the short position with the oldest existing long position.
(C) The exchange randomly chooses a party that holds a long position in the contract to take that delivery.
(D) The broker of the short position negotiates directly with a network of long position brokers.

Oct/Nov 2011

65. A bank has a bond portfolio valued at ₹ 20 million with a modified duration of 7.9612. Expecting a 50 basis points (0.5%) increase in yield, the bank wants to assess the impact. What is the percentage change in the portfolio price given the 50 bp increase in yield?
(A) -1.9806%
(B) -3.9806%
(C) -7.9612%
(D) -8.2000%

May/June 2010

66. A banker finds a current yield of 6.5% attractive and wants to lock it in for an expected cash inflow of ₹ 1.00 crore. The banker buys 10 lots of 6.0% GOI 2031 futures at ₹ 92.59. Lot size is 2000. What is the total value of the futures contract bought?
(A) ₹ 18,51,800
(B) ₹ 18,61,400
(C) ₹ 9,25,900
(D) ₹ 19,00,000

Oct/Nov 2024

67. A trader holding a short position in physically settled futures decides to make a delivery during the exchange-mandated delivery period. What specific information must the notice of intention issued to the clearinghouse contain?
(A) The purchase price, initial margin, variation margin, and identity of the long position holder.
(B) The preferred settlement price, total mark-to-market gain, and alternative cash settlement options.
(C) The contact details of the randomly selected buyer and their corresponding broker.
(D) The number of contracts to be delivered, the location of the delivery, and the grade that will be delivered.

May/June 2017

68. A bank has a bond portfolio valued at ₹ 2,00,00,000. The bank wants to restrict the loss to ₹ 3,00,000.
Using the formula DT = (3,00,000 / 2,00,00,000) × [(1 + 0.03) / 0.005]
What is the targeted duration DT for the portfolio?
(A) 1.55
(B) 2.09
(C) 3.09
(D) 4.09

Oct/Nov 2005

69. A banker initiated a long position valued at ₹ 18,51,800. Later, the position was squared off and sold at a total value of ₹ 18,61,400. Based on the transaction, what is the realized gain from squaring off the futures position?
(A) ₹ 5,600
(B) ₹ 8,200
(C) ₹ 9,600
(D) ₹ 10,400

May/June 2020

70. During the exchange-mandated delivery period of a futures contract, who has the authority to decide the exact delivery time?
(A) The exchange clearinghouse

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changes. The manager must determine the required duration adjustment and the number of contracts needed to achieve it. However, since most hedging activities are cash-settled or closed before maturity, the physical delivery location is usually irrelevant for the duration management strategy.

25. (B) Forward markets are far more transparent than futures markets because their prices and volume are widely reported.
Futures markets are characterized by high transparency because all trades occur on organized exchanges where price and volume data are publicly reported in real-time. In contrast, forward contracts are private over-the-counter agreements. Information about forward trades is not centrally recorded or widely disseminated, making them significantly less transparent than their exchange-traded futures counterparts for all market participants.

26. (D) The process of updating the margin account daily based on the daily settlement price of the contract.
Marking-to-market is a fundamental risk management process where the value of a futures position is adjusted daily. At the end of each trading session, the exchange uses the official settlement price to determine the gain or loss for each participant. This amount is then immediately added to or subtracted from the trader's margin account, ensuring positions reflect current market values.

27. (A) When the futures price is above the expected future spot price, resulting in an upward sloping forward curve.
Contango describes a market condition where the futures price of a commodity or financial instrument is higher than the current spot price. This situation typically results in an upward-sloping forward curve. It often occurs when the costs of carrying the asset, such as storage, insurance, and financing, exceed any benefits or income derived from holding the underlying physical asset.

28. (A) Entering an opposite market position to offset the original trade and exit the contract before its maturity.
To limit potential losses when market prices move unfavorably, a futures trader can exit their obligation through an offsetting trade. This involves entering a transaction that is exactly opposite to the original one. For example, a buyer can sell the same number of contracts. This process, known as squaring off, cancels out the original position and stops further losses.

29. (C) Allowing parties to customize delivery dates and contract sizes privately.
Futures exchanges use several mechanisms to ensure contract compliance and reduce default risk. These include the use of a central clearinghouse, mandatory initial and maintenance margins, and daily marking-to-market. Allowing private customization of delivery dates or contract sizes is a feature of forward contracts, not futures, as customization would reduce liquidity and complicate the standardized clearing process for participants.

30. (D) The futures price is below the expected future spot price, often due to the benefits of owning the physical material.
Normal backwardation is a market theory suggesting that the futures price should be lower than the expected future spot price. This situation often occurs when hedgers, such as producers, are willing to sell at a discount to lock in prices. It can also happen when the convenience yield of holding the physical asset is higher than the total carrying costs involved.

31. (C) Expectation of interest rate falling — Take a long future position.
In interest rate futures, there is an inverse relationship between rates and prices. If a trader expects interest rates to fall, they anticipate bond prices will rise. To profit from this movement, they should take a long futures position. Conversely, if rates are expected to rise, bond prices will fall, making a short position more appropriate for profit.

32. (B) (I), (III), (IV), and (V)
Futures contracts offer several advantages over forwards, including high levels of national regulation and centralized exchange

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mechanisms to prevent non-compliance. Their standardized nature facilitates high liquidity, allowing participants to easily offset positions. Furthermore, the prices of liquid, nearby futures contracts often serve as reliable price discovery tools for the broader decentralized markets where the underlying assets are traded.

33. (A) P-2, Q-1, R-3, S-4
Hedging strategies are selected based on market expectations. If interest rates are expected to rise, bond prices will fall, necessitating a short future position or selling contracts. Conversely, if rates are expected to fall, bond prices will rise, requiring a long position or buying contracts. These strategies ensure that gains in the futures market offset losses in the cash market.

34. (C) Assertion (A) is true, but Reason (R) is false.
Contango occurs when futures prices exceed the expected spot price, typically due to significant carrying costs like storage and interest. However, a high convenience yield, which represents the benefit of holding the physical asset, actually reduces the futures price relative to the spot price. Therefore, high convenience yields lead to backwardation rather than contango, making the provided reasoning logically incorrect.

35. (C) Both (I) and (II)
Convergence is the process where futures and spot prices meet at maturity. In physically delivered contracts, arbitrage ensures this happens because any price gap would allow for risk-free profit through delivery. For cash-settled contracts, the exchange formally mandates convergence by setting the final settlement price equal to the prevailing spot market price at the end of the final trading period.

36. (B) Loss of ₹ 30,000; Balance ₹ 50,000
The loss is calculated by multiplying the price change per ton by the total tonnage. The price fell by one hundred fifty rupees per ton on twenty contracts of ten tons each, totaling two hundred tons. This results in a thirty-thousand-rupee loss. Subtracting this from the eighty-thousand-rupee opening balance leaves exactly fifty thousand rupees in the margin account balance.

37. (A) P-3, Q-4, R-2, S-1
Margin accounts utilize specific terms to manage risk. The initial margin is the amount deposited when opening a position. The variation margin is the minimum maintenance level. A margin call is a request for extra funds if the balance drops below this level. Marking-to-market is the daily process of adjusting the account balance based on the current settlement price.

38. (B) (I), (II), and (IV)
A trader must monitor their margin account to ensure it stays above the variation margin. If it falls below this threshold, they receive a margin call to restore the balance. Failing to provide these funds gives the broker the legal authority to close the position. This system protects both the broker and the clearinghouse from potential defaults during market volatility.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Futures and spot prices must converge at expiration to prevent arbitrage. If the futures price were significantly different from the spot price on the final day, traders could buy in the cheaper market and sell in the more expensive one for a risk-free profit. Market efficiency ensures that these arbitrage opportunities are eliminated, forcing the prices to align perfectly at maturity.

40. (D) Settlement price — Always the price of the very first trade executed at the opening of the exchange.
The settlement price is not determined by the opening trade of the day. Instead, it is a calculated value, usually the volume-weighted average of trades during the final thirty minutes of the session. This methodology ensures that the price used for marking-to-market reflects the most recent and relevant market conditions rather than a potentially volatile opening trade price.

41. (A) ₹ 19,62,000
To find the total value of the square-off position, the number of lots is multiplied by the lot size and the purchase price. Here, ten lots of two thousand bonds each were bought back at ninety-eight rupees and ten paise. This

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calculation results in a total value of nineteen lakh sixty-two thousand rupees, representing the cost to close the original position.

42. (B) P-4, Q-2, R-1, S-3
Futures and forwards have distinct characteristics. Futures are highly standardized, which facilitates liquidity on organized exchanges but reduces flexibility. They utilize a clearinghouse to eliminate performance risk. In contrast, forward contracts are non-negotiable, meaning they lack an easy way to offset positions, and they are tailor-made to suit the specific needs of the private parties involved in the trade.

43. (A) (I), (II), and (IV)
Interest rate futures were introduced in India in 2003 and are subject to strict regulatory oversight, requiring approval before new products are launched. Current market offerings include ninety-one-day Treasury bill futures. These contracts use standardized lot sizes and notional values. Although multipliers vary, the standard lot size for interest rate futures traded on Indian exchanges is typically two thousand bonds.

44. (B) (I) and (III)
While thousands of futures contracts are traded daily, the vast majority are settled in cash or closed out before maturity, making actual physical delivery rare. If delivery does occur, the exchange manages the process by randomly selecting a long position holder to receive the asset from a short position holder who has issued a formal notice of intention to deliver.

45. (C) ₹ 80,000
The trader initially posts a five percent margin on twelve lakh rupees, which is sixty thousand rupees. When the price increases by one hundred rupees per ton on two hundred tons, a twenty-thousand-rupee gain is realized. After marking-to-market, this gain is added to the initial margin, resulting in a new margin account balance of exactly eighty thousand rupees.

46. (B) P-3, Q-4, R-1, S-2
Market curves are defined by the relationship between spot and futures prices. Contango results in an upward-sloping curve, while normal backwardation occurs when futures prices are below expected spot prices. Warehouse stock levels also play a role; high stocks usually lead to low convenience yields, whereas low stocks can create high convenience yields, influencing the overall shape of the forward curve.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Forward contracts carry significant counterparty risk because they are private agreements without a central guarantor. Since the entire financial obligation is settled only on the expiration date, one party may face a large loss that exceeds their ability to pay, leading to a default. This risk is amplified because there is no daily settlement to manage exposure during the contract term.

48. (B) Margin call triggered — When the margin account balance falls below the initial margin amount.
A margin call is not triggered when the balance falls below the initial margin. Instead, it occurs when the account balance drops below the variation margin, which is the minimum maintenance level. Once triggered, the trader must provide enough funds to bring the balance all the way back up to the initial margin level, not just back to the maintenance level.

49. (A) (I), (III), (IV), and (V)
Managing portfolio duration with futures is an efficient strategy because transaction costs are lower than buying or selling physical bonds. Taking a short position reduces duration, protecting against rising rates. Conversely, a long position increases duration, benefiting from falling rates. This flexibility allows managers to adjust the price sensitivity of their portfolios quickly in response to changing market expectations for rates.

50. (C) (II) and (III)
The pricing of futures contracts is influenced by both the theoretical cost of carry and market forces like demand and supply. A holistic approach is used to determine the price, which reflects the monetary value of the risks involved. Participants will only enter a contract if they

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69. (C) ₹ 9,600
The realized gain is the difference between the value of the position when it was squared off and its value when it was initiated. The square-off value was eighteen lakh sixty-one thousand four hundred rupees, while the initial value was eighteen lakh fifty-one thousand eight hundred rupees. Subtracting the initial value from the final value results in a gain of nine thousand six hundred rupees.

70. (B) The party with the short position
While the exchange sets the overall delivery period for a futures contract, the party with the short position has the authority to choose the exact day within that window to make the delivery. This flexibility allows the seller to optimize their logistics and inventory management, while the buyer must be prepared to accept delivery whenever the seller initiates the process.

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60. (B) (I) and (III)
Contango occurs when the forward curve slopes upward because futures prices are higher than spot prices, often due to storage and financing costs. This is common in physically delivered contracts. Normal backwardation, however, describes a situation where the futures price is below the expected spot price, which is the opposite of the scenario mentioned in the incorrect statement regarding the forward curve shape.

61. (C) 72 contracts
Using the provided duration adjustment formula, the manager calculates the required number of contracts to shift the portfolio duration from eight point two to three point zero nine. By plugging the values into the formula and dividing the target change by the product of the futures duration and price per lot, the resulting calculation determines that seventy-two contracts must be shorted accordingly.

62. (B) ₹ 18,61,400
The total value at square-off is found by multiplying the number of lots by the lot size and the current market price. The banker had ten lots, each with two thousand bonds, and sold them when the price reached ninety-three rupees and seven paise. Multiplying ten by two thousand by ninety-three point zero seven gives a total sale value of eighteen lakh sixty-one thousand four hundred rupees.

63. (B) Profit of ₹ 98,000
The net profit or loss is the difference between the initial sale value and the subsequent purchase value in a short hedging strategy. The bank sold ten lots for twenty lakh sixty thousand rupees and bought them back for nineteen lakh sixty-two thousand rupees. Since the buyback price was lower than the selling price, the bank realized a profit of ninety-eight thousand rupees.

64. (C) The exchange randomly chooses a party that holds a long position in the contract to take that delivery.
When a short position holder decides to make a physical delivery, they notify the clearinghouse of their intent. The exchange then takes responsibility for identifying the counterparty. This is done by randomly selecting a market participant who currently holds an open long position in the same contract. This random selection ensures fairness and neutrality in the fulfillment of delivery obligations between parties.

65. (B) -3.9806%
The percentage change in the price of a bond portfolio can be estimated by multiplying the modified duration by the change in yield. Here, the modified duration is seven point nine six one two and the yield increase is zero point five percent. Multiplying these values results in a price decrease of three point nine eight zero six percent, illustrating the portfolio's sensitivity to rates.

66. (A) ₹ 18,51,800
A banker locking in a yield buys ten lots of futures. With each lot containing two thousand bonds and a purchase price of ninety-two rupees and fifty-nine paise, the total investment is calculated by multiplying these three factors together. This results in a total value of exactly eighteen lakh fifty-one thousand eight hundred rupees for the initiated long position in the futures market.

67. (D) The number of contracts to be delivered, the location of the delivery, and the grade that will be delivered.
A notice of intention is a formal document submitted by the seller to the clearinghouse to start the delivery process. It must specify critical logistical details to ensure a smooth transfer. These details include the exact number of contracts being delivered, the specific grade or quality of the asset, and the approved location where the physical delivery will take place.

68. (C) 3.09
The targeted duration is calculated using a specific formula that relates the maximum acceptable loss to the total portfolio value and interest rate volatility. By dividing the three-lakh-rupee loss limit by the twenty-million-rupee portfolio value and multiplying by the ratio of the interest factor to the yield change, the resulting targeted duration for the portfolio is exactly three point zero nine.

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mutually share the potential loss incurred on an underlying asset.

May/June 2016

8. Match the following conditions for a Long Call at expiration (List I) with their respective outcomes (List II):
List I: (Condition)
P. $S_T > K$ (Decision)
Q. $S_T \leq K$ (Decision)
R. $S_T > K$ (Long call P&L)
S. $S_T \leq K$ (Long call P&L)
List II: (Outcome)
1. Option will not be exercised
2. $-c_0$
3. $S_T - K - c_0$
4. Option will be exercised
(A) P-1, Q-4, R-2, S-3
(B) P-4, Q-1, R-3, S-2
(C) P-4, Q-2, R-1, S-3
(D) P-3, Q-1, R-4, S-2

Oct/Nov 2006

9. Identify the correct statement regarding the moneyness of a call option.
(A) A call option is In-the-money (ITM) when the value of the underlying asset is less than the strike price.
(B) ATM occurs when the asset price equals the strike price, resulting in a zero payoff regardless of exercise.
(C) A call option is Out-of-the-money (OTM) when the value of the underlying asset is greater than the strike price.
(D) Moneyness applies equally to options, forwards, and futures contracts as all counterparties get to choose whether to exercise.

May/June 2019

10. All of the following correctly describe "exercising an option contract" EXCEPT:
(A) It is the act of claiming the right to buy/sell the options contract at the end of the expiry.
(B) In the context of a call option, it means claiming the right to buy the stock at the agreed strike price.
(C) The buyer would typically do it even when it is not beneficial to them, to recover the premium.
(D) If the option is not beneficial, the buyer will let it expire without exercising it.

Oct/Nov 2022

11. Match the following Long Put relationships (List I) with their corresponding P&L and Payoff metrics (List II):
List I: (Relationship)
P. Long put payoff when $S_T \leq K$
Q. Long put payoff when $S_T < K$
R. Long put P&L when $S_T \geq K$
S. Long put P&L when $S_T < K$
List II: (Metric)
1. $K - S_T$
2. $K - S_T - p_0$
3. 0
4. $-p_0$
(A) P-1, Q-2, R-3, S-4
(B) P-4, Q-3, R-1, S-2
(C) P-3, Q-4, R-1, S-2
(D) P-3, Q-1, R-4, S-2

May/June 2021

12. In the context of derivatives, how does an options contract primarily differ from forward and futures contracts?
(A) Both counterparties in an options contract are bound by equal obligations to complete the transaction upon maturity.
(B) An options contract requires no upfront premium unlike forward contracts which demand initial margin from all parties.
(C) The buyer has the right, but not the obligation, to trade the asset, providing flexibility not found in futures.
(D) Options contracts strictly follow a zero-sum game where neither party can gain more than the other's loss in value.

NODIA

Oct/Nov 2010

13. An investor buys a European-style call option on an underlying stock. The strike price is $K = 850$. The underlying asset price at expiration turns out to be $S_T = 810$. What is the payoff to the short call position?
(A) 0
(B) ₹ 40
(C) -₹ 40
(D) ₹ 850

May/June 2005

14. Identify the incorrect statement regarding the mechanics of a call option.

CHAPTER 37
Options

Oct/Nov 2018

1. The money required to be paid by the option buyer to the option seller/writer to acquire the right to exercise a desire to buy or sell the asset at the strike price is known as:
(A) Settlement Margin
(B) Intrinsic Difference
(C) Strike Advance
(D) Option Premium

May/June 2007

2. The long call's breakeven point is exactly where the price of the underlying asset received equals:
(A) The premium paid minus the strike price.
(B) The strike price divided by the call premium.
(C) The combination of both the premium and strike price paid ($S_T = K + c_0$).
(D) The intrinsic value multiplied by the underlying asset price.

Oct/Nov 2014

3. Arrange the following milestones in the international options market in chronological order of their inception:
I. Exchange-traded options on currencies began on the Philadelphia Stock Exchange.
II. Customized options were available as Over the Counter (OTC) mainly on commodities.
III. Options on equities began trading on the Chicago Board Options Exchange (CBOE).
IV. Interest rate options began trading on the CME.
(A) II, III, I, IV
(B) III, II, IV, I
(C) II, I, III, IV
(D) I, III, II, IV

May/June 2023

4. The fee paid by the long put to the short put for providing the right to sell is known as:
(A) The put penalty
(B) The put margin
(C) The put premium
(D) The exercise discount

Oct/Nov 2025

5. Which of the following best explains why the long call must pay a "call premium" to the short call?
(A) The long call assumes the obligation to buy the asset, thereby increasing the total risk profile of the position.
(B) Premium is the fee paid to the short call in exchange for the long call receiving a right without any obligation.
(C) The short call holds the right to cancel the contract at any time, requiring specific compensation from the long call.
(D) The premium acts as a security deposit that is eventually returned to the long call upon the contract's expiration.

May/June 2012

6. The equation that describes the payoff to the long put is $\max(K - S_T, 0)$. Which of the following variables is NOT part of this specific long put payoff calculation?
(A) K (Strike Price)
(B) c_0 (Call premium)
(C) S_T (Underlying asset price at time T)
(D) 0 (Zero payoff boundary)

Oct/Nov 2009

7. What is an options contract?
(A) An agreement providing the right and obligation to transact an asset at a future date at a spot price.
(B) A contract giving the right, but not the obligation, to buy or sell an asset at a set price for a specific time.
(C) An agreement mandating both counterparties to exchange underlying assets at a floating interest rate in the future.
(D) An agreement where the buyer and seller

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believe the price adequately shields them from specific risks or offers a profitable investment opportunity.

51. (C) ₹ 20,60,000
The total value of a futures contract is determined by multiplying the number of lots by the size of each lot and the agreed-upon price. In this scenario, ten lots consisting of two thousand units each were sold at a price of one hundred three rupees. Multiplying these figures results in a total contract value of exactly twenty lakh sixty thousand rupees.

52. (A) Cost of carry model — Used to calculate the price of both forward and futures contracts.
The cost of carry model is a universal principle used to price both forward and futures contracts by adding the spot price to financing and storage costs. Other concepts like cash settlement do not involve physical transfer, convenience yields are inversely related to inventory, and the delivery timing in futures is typically the prerogative of the seller, not the buyer.

53. (A) Only (I)
Cash settlement is a common method for closing out futures contracts, especially for stock indices. On the final trading day, the contract is marked to market one last time based on the closing spot price. All open positions are then formally declared closed. No physical assets are exchanged; instead, the final profit or loss is settled through the margin account balance.

54. (D) Assertion (A) is false, but Reason (R) is true.
A margin call is only issued when an account balance falls below a certain threshold, meaning the assertion that it is issued when the balance is high is false. However, traders are indeed allowed to withdraw excess funds from their margin accounts if the balance exceeds the initial margin requirement, providing them with liquidity from their daily realized gains.

55. (B) (I), (III), and (IV)
Hedging with interest rate futures involves matching futures positions with cash positions to mitigate price risk. Because bond prices and interest rates move in opposite directions, a short position in futures will profit when interest rates rise and bond prices fall. For an effective hedge, the chosen futures contract must have a high correlation with the cash market rates involved.

56. (A) P-4, Q-3, R-1, S-2
In the Indian interest rate futures market, specific products like ninety-one-day Treasury bill futures are offered. For bond futures, the underlying typically consists of government securities with residual maturities ranging from four to eight years. A standard lot size consists of two thousand bonds, leading to a total notional face value of two lakh rupees for each lot traded on the exchange.

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57. (B) ₹ 60,000
To calculate the initial margin, one must first find the total contract value. Here, twenty futures of ten tons each at six thousand rupees per ton result in a total value of twelve lakh rupees. Applying the five percent margin requirement to this total value results in an initial margin amount of sixty thousand rupees that must be posted by the member involved.

58. (A) Only (I)
The clearinghouse plays a vital role by tracking all daily transactions to determine the net obligations of every clearing member. It does not maintain a single consolidated account; rather, it manages separate margin requirements for each clearing member based on their specific net positions. This individualized tracking is essential for accurately monitoring and managing the credit risk of each market participant.

59. (A) (I), (III), (IV), and (V)
The clearinghouse is a central intermediary that manages risk through margin requirements and daily marking-to-market. The variation margin represents the maintenance level below which a margin call is triggered. Clearing members provide a clearing margin to the clearinghouse. This systematic process ensures that gains are credited and losses are debited daily, maintaining the financial integrity of the entire futures exchange system.

(A) The two counterparties to a call option are the long call and the short call.
(B) The short call is obligated to sell the underlying asset to the long call should the long call exercise its right to purchase.
(C) The short call is also referred to as the "buyer" and the long call as the "seller" or "writer".
(D) The price at which the long call has the right to purchase the underlying asset is known as the strike price or exercise price.

Oct/Nov 2016

15. The payoff associated with a long put is based on whether the long put exercises its right. When does the long put exercise?
(A) When the strike price that the long put can receive is less than the underlying asset price that it must deliver.
(B) When the current market price of the underlying asset is exactly equal to the paid option premium amount.
(C) Only in scenarios where the put premium is voluntarily refunded to the buyer by the short put counterparty.
(D) When the strike price is greater than the market price, allowing the buyer to sell the asset at a higher rate.

May/June 2018

16. Which of the following is currently NOT listed as an available underlying asset for trading options?
(A) Real estate physical assets
(B) Foreign currencies
(C) Commodities
(D) Futures contracts

Oct/Nov 2007

17. What describes a put option?
(A) An agreement providing the long put the right to sell an underlying asset to the other counterparty in the future.
(B) An agreement where the long put provides the right to purchase the underlying asset.
(C) An agreement where the short put has the obligation to sell the underlying asset.
(D) An agreement ensuring both counterparties must sell an asset at a floating price.

May/June 2014

18. Identify the correct statement regarding the profit and loss dynamics in an options contract.
(A) The buyer of the option will benefit whenever the price moves in their favour, and this benefit is not shared with the seller.
(B) Both the buyer and the seller share the benefit if the price moves in the buyer's favour.
(C) The seller enters the contract because they always gain regardless of price movement.
(D) A single party can make a gain beyond the loss of the other party in an options zero-sum game.

Oct/Nov 2019

19. Identify the incorrect statement regarding a short call.
(A) The short call has no choice in the matter of whether the transaction takes place.
(B) The short call earns the smaller of two possible payoffs, either $K - S_T$ or zero.
(C) The short call's payoff is represented by $\min(K - S_T, 0)$.
(D) The short call's P&L at expiration is exactly equal to its payoff without factoring in the premium received.

May/June 2025

20. Consider the following statements regarding the long call's Profit and Loss (P&L):
I. P&L is equal to the payoff for a forward contract as there is no premium associated with a forward at initiation.
II. A call option's payoff is exactly equal to its P&L at expiration.
III. The long call option's P&L at expiration is expressed as $\max(S_T - K, 0) - c_0$.
Which of the above statement(s) is/are correct?
(A) I and II only
(B) II and III only
(C) I and III only
(D) I, II, and III

Oct/Nov 2011

21. Identify the correct pairing for the moneyness of a Put Option:
(A) $S_T > K$: ITM (In-the-money)
(B) $S_T = K$: OTM (Out-of-the-money)
(C) $S_T < K$: ITM (In-the-money)

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(D) $S_T < K$: ATM (At-the-money)

May/June 2009

22. Which of the following defines a call option?
(A) An agreement giving the purchaser the right to sell the underlying asset at a fixed price at a future time.
(B) An agreement giving the purchaser the right to buy the underlying asset at a fixed price at a future time.
(C) An agreement giving the option writer the right to buy the underlying asset at a fixed price at a future time.
(D) An agreement requiring the purchaser to buy the underlying asset at a floating price at a future time.

Oct/Nov 2024

23. In options terminology, what does "at-the-money" signify?
(A) Exercising the option is highly likely to result in a massive loss relative to the premium.
(B) The price of the underlying asset is such that exercising the option will provide a maximum gain.
(C) The long position will earn a positive pay-off regardless of the exercise decision.
(D) The price of the underlying asset is very close to or equal to the exercise price.

May/June 2010

24. What does the term "deep-ITM" subjectively indicate for a call option?
(A) The underlying asset price is marginally above the strike price.
(B) The underlying asset price is substantially lower than the strike price.
(C) The underlying asset price precisely matches the breakeven point.
(D) The underlying asset price is much higher than the strike price.

Oct/Nov 2005

25. Identify the correct pairing of the scenario with the Short Call P&L at expiration:
(A) $S_T > K$: $K - S_T - c_0$
(B) $S_T \leq K$: c_0
(C) $S_T > K$: $S_T - K$
(D) $S_T \leq K$: 0

NODIA

May/June 2017

26. Arrange the history of the Indian derivative markets based on their launch dates in sequential order:
I. Stock options were launched
II. Index futures were launched
III. Single stock futures were launched
IV. Index options were launched
(A) II, IV, I, III
(B) IV, II, III, I
(C) II, I, IV, III
(D) I, II, III, IV

Oct/Nov 2015

27. Identify the incorrect statement regarding put options.
(A) A put option gives the long put the obligation to sell an underlying asset to the short put in the future.
(B) The price at which the long put has the right to sell the asset is known as the strike price or exercise price.
(C) The short put is obligated to purchase the underlying asset from the long put should the long put exercise its right to sell.
(D) A European style put option provides the long put the right to exercise only at expiration.

May/June 2020

28. What distinguishes an American option from a European option?
(A) American options allow exercise anytime until maturity, while European options only allow exercise on the expiration date.
(B) American options allow exercise only at expiration, while European options allow for exercise at any time during the term.
(C) American options trade exclusively on Over the Counter markets, whereas European options trade only on regulated exchanges.
(D) American options require lower premiums due to restricted timelines for exercise when compared to standard European options.

Oct/Nov 2021

29. Consider the following statements about call options as zero-sum games:
I. Any profit one counterparty receives is exactly equal to the loss the other suffers.

II. The net P&L across the long and short calls is zero.
III. When $S_T > K$, the long call P&L is $S_T - K - c_0$ and the short call P&L is $K - S_T + c_0$.
IV. When $S_T \leq K$, the long call P&L is c_0 and the short call P&L is $-c_0$.

Which of the above statement(s) is/are correct?
(A) I, II, and III
(B) II, III, and IV
(C) I, II, and IV
(D) I, III, and IV

May/June 2013

30. Consider the following statements about a long call payoff:
I. The long call exercises when the underlying asset price is less than the strike price.
II. The payoff to the long call is represented by $\max(S_T - K, 0)$, where S_T is the underlying asset price at time T, and K is the strike price.

Which of the above statement(s) is/are correct?
(A) Only I is correct.
(B) Only II is correct.
(C) Both I and II are correct.
(D) Neither I nor II is correct.

Oct/Nov 2008

31. An investor writes a short put option. The strike price is 115. The underlying asset price at expiration is ₹ 125. The premium received at initiation is ₹ 8. What is the short put P&L?
(A) -₹ 10
(B) ₹ 0
(C) ₹ 8
(D) -₹ 2

May/June 2024

32. A borrower buys a one-year interest rate cap with a notional principal amount of ₹ 1 million and a cap rate (r_c) of 5% (0.050). The reference index resets to 5.5% (0.055). The number of days from the interest rate reset date to the payment date (d_t) is 184 days. What is the amount owed by the seller to the buyer on the next payment date? Use the formula: $(N) \times \max(0, r - r_c) \times (d_t/365)$.
(A) ₹ 5,500.00
(B) ₹ 2,520.55
(C) ₹ 0.00
(D) ₹ 25,205.50

Oct/Nov 2017

33. Identify the incorrect pair regarding the short put at expiration when $S_T < K$:
(A) Short put payoff : $S_T - K$
(B) Exercise decision : Option will not be exercised
(C) Short put P&L : $S_T - K + p_0$
(D) Net P&L across counterparties : 0

May/June 2006

34. Consider the following statements regarding interest rate collars and reverse collars:
I. The purchase of an interest rate collar is the simultaneous purchase of a cap and sale of a floor.
II. A borrower buys a collar to limit effective borrowing rates between a maximum and a minimum.
III. A reverse collar involves buying an interest rate floor and simultaneously selling a cap.
IV. A bank buys a reverse collar to protect against rising interest rates.
V. When the index is above the cap rate in a normal collar, the buyer receives a payment.

Which of the above statement(s) is/are correct?
(A) I, II, III, and V
(B) I, II, IV, and V
(C) II, III, IV, and V
(D) I, III, IV, and V

Oct/Nov 2013

35. Match the following notation from the Black-Scholes pricing model (List I) to its definition (List II):
List I: (Notation)
P. r_t
Q. t
R. T
S. $N()$
List II: (Definition)
1. Expiration date
2. Valuation date
3. The standard normal cumulative distribution function
4. Continuously compounded risk-free interest rate on the valuation date

(A) P-4, Q-2, R-1, S-3

NODIA

Oct/Nov 2007

60. What defines a floating-rate loan in the context of interest rate caps, collars, and floors?
(A) The interest rate is fixed exclusively by the borrower's credit rating at the start of the loan.
(B) A loan where the rate fluctuates based on a market benchmark, often set as a reference rate plus a specific premium.
(C) The interest rate cannot exceed the benchmark MIBOR without obtaining specific government approval for the variance.
(D) The rate is determined by the Black-Scholes implied volatility of the borrower's equity in the current period.

May/June 2025

61. A call option has a strike price of ₹ 300. As expiration approaches, the underlying asset trades at ₹ 290. The long call holder is evaluating their position. Which decision is strictly rational according to the payoff mechanics, and what is the resulting moneyness?
(A) Exercise the option to realize a payoff; the option is ITM.
(B) Exercise the option as it is ATM and earns zero payoff.
(C) Do not exercise the option to avoid a negative payoff; the option is OTM.
(D) Sell the obligation back to the short call for a refund; the option is OTM.

Oct/Nov 2019

62. A portfolio manager holds ₹ 10 million in a particular equity index and is concerned about a potential market crash in the next three months. However, they want to retain the upside potential if the market rallies. Which option strategy optimally aligns with this objective?
(A) Buy an index put option.
(B) Buy an index call option.
(C) Sell an index put option.
(D) Sell an index call option.

May/June 2009

63. Consider the following statements on option P&L and moneyness:
I. "Moneyness" refers to whether the long position to an option will exercise or not.
II. A call option is ITM when the long call will earn a positive payoff through exercising.
III. A put option is OTM when the long put will not exercise as it would earn a negative payoff.
IV. ATM options always earn a high positive payoff for the long position.
V. A put option is ITM when the long put will earn a positive payoff by exercising when the underlying price is less than the strike price.
Which of the above statement(s) is/are correct?
(A) I, II, III, and V
(B) II, III, IV, and V
(C) I, III, IV, and V
(D) I, II, IV, and V

Oct/Nov 2011

64. A corporate borrower expects interest rates to rise. Instead of taking a fixed-rate loan, they take a floating-rate loan and purchase an interest rate cap. Why might this combination be strategically superior for the borrower compared to simply fixing the interest rate via a forward contract?
(A) The cap completely eliminates the obligation to pay any interest.
(B) The cap ensures they receive fixed interest payments from the lender.
(C) Caps limit maximum borrowing costs while allowing users to benefit from lower rates if the market drops.
(D) The cap removes the need to pay any premium, unlike a forward contract.

May/June 2010

65. A speculator purchases a long put option on a commodity with a strike price of ₹ 1,000, paying a premium of ₹ 50. At expiration, the commodity price drops to ₹ 800. What is the speculator's net P&L?
(A) ₹ 200
(B) ₹ 150
(C) ₹ 250
(D) -₹ 50

Oct/Nov 2024

66. An airline company expects fuel prices to surge over the next six months. To lock in a maximum purchase price without being obligated to buy if prices unexpectedly drop,

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result in a loss.

(D) When the value of the underlying asset drops to zero, maximizing the long put payoff.

May/June 2016

43. The following question consists of two statements, one labeled Assertion (A) and the other labeled Reason (R). Select the correct answer using the codes given below:

Assertion (A): In an interest rate cap, if the specified market index is below the cap rate, the buyer receives no payment and loses the premium paid for the cap.

Reason (R): The buyer of a cap bears an obligation to pay the seller if the interest rates fall below the cap rate.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

(C) Assertion (A) is true, but Reason (R) is false.

(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2009

44. Consider the following statements regarding interest rate options:

I. In interest rate options, buying and selling interest rates is not possible if the option is exercised.

II. Interest rate calls and interest rate puts generally trade on exchanges.

III. Interest rate caps, floors, and collars are usually traded on exchanges rather than over-the-counter markets.

Which of the above statement(s) is/are correct?

(A) I and II only

(B) II and III only

(C) I and III only

(D) I, II, and III

May/June 2023

45. A firm has a variable-rate loan and wishes to limit its maximum borrowing rate but does not want to pay any net premium up front. The firm executes a strategy where it buys a cap and sells a floor, ensuring the premiums cancel each other out. What is the primary negative consequence of this specific "zero cost" strategy for the buyer?

(A) The buyer is exposed to unlimited risk if interest rates rise exponentially.

(B) The buyer must pay double the transaction costs at maturity.

(C) The strategy limits any potential gains from falling interest rates below the floor level.

(D) The buyer assumes the obligation of a naked put option on equities.

Oct/Nov 2018

46. Consider the following statements regarding the short put:

I. The short put is obligated to purchase the underlying asset from the long put should the long put exercise.

II. The short put will experience a negative payoff if the underlying asset price is less than the strike price.

III. The short put payoff equation is $\min(S_T - K, 0)$.

IV. A positive value for the short put's P&L represents profit.

V. When $S_T \geq K$, the short put P&L is equal to $-p_0$.

Which of the above statement(s) is/are correct?

(A) I, II, III, and IV

(B) I, III, IV, and V

(C) II, III, IV, and V

(D) I, II, IV, and V

May/June 2007

47. The following question consists of two statements, one labeled Assertion (A) and the other labeled Reason (R). Select the correct answer using the codes given below:

Assertion (A): Buying a zero-cost collar allows a borrower to establish limits on effective borrowing rates without paying an up-front premium.

Reason (R): A zero-cost collar is designed by choosing cap and floor rates such that the premium paid for the cap is exactly offset by the premium received from selling the floor.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).

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(B) P-1, Q-3, R-4, S-2
(C) P-4, Q-1, R-2, S-3
(D) P-2, Q-4, R-3, S-1

May/June 2008

36. A bank holds a massive portfolio of floating-rate loans. Expecting interest rates to drop drastically, the bank wishes to establish a minimum guaranteed rate of return on these loans while offsetting the cost of this protection. Which strategy should the bank implement?
(A) Buy a reverse collar (buy an interest rate floor and sell an interest rate cap).
(B) Buy an interest rate cap only.
(C) Buy an interest rate collar.
(D) Sell an interest rate floor only.

Oct/Nov 2012

37. A long put option is purchased with a strike price of $K = 122$. The underlying asset price at expiration is $S_T = 133$. The put premium paid at initiation is $p_0 = 7$. What is the long put P&L?
(A) -₹ 7
(B) ₹ 4
(C) ₹ 11
(D) 0

May/June 2015

38. Consider the following statements about an interest rate cap:
I. An interest rate cap is an agreement that limits the buyer's interest rate exposure to a minimum rate.
II. Buying a cap is actually the purchase of a call option on an interest rate.
Which of the above statement(s) is/are correct?
(A) Only I is correct.
(B) Only II is correct.
(C) Both I and II are correct.
(D) Neither I nor II is correct.

Oct/Nov 2020

39. Match the following concepts regarding Interest Rate Floors (List I) with their descriptions (List II):
List I: (Concept)
P. A multi-period floor
Q. Payment formula for floor
R. Selling an FRA at a forward rate
S. Primary negative of buying an in-the-money floor
List II: (Description)
1. High premium payment
2. $(N) \times \max(0, r_f - r) \times (d_t/365)$
3. Equivalent payoff structure to receiving a payment when index falls below floor rate
4. Viewed as a bundle of European style put options on a sequence of FRAs
(A) P-1, Q-3, R-2, S-4
(B) P-4, Q-1, R-3, S-2
(C) P-2, Q-4, R-1, S-3
(D) P-4, Q-2, R-3, S-1

May/June 2011

40. According to the Black-Scholes-Merton model formula for a long call option (c_t), which expression represents the term d_1?
(A) $d_1 = \dfrac{\ln(K/S_t) + (r_t - \sigma_t^2/2)(T-t)}{\sigma_t sqrt T - t}$
(B) $d_1 = \ln(\frac{S_t}{K}) \cdot \sigma_t sqrt T - t$
(C) $d_1 = d_2 + \sigma_t \sqrt{T-t}$
(D) $d_1 = \dfrac{\ln(S_t/K) + (r_t + sigma_t^2/2)(T-t)}{\sigma_t \sqrt{T-t}}$

Oct/Nov 2023

41. Identify the correct statement regarding the decision to exercise an American-style option.
(A) An investor should exercise an American-style call option only when the risk-free rate is zero.
(B) Put options are exercised early if the benefit of receiving the strike price outweighs the loss of time value.
(C) An investor must always exercise an American-style option immediately upon purchase to lock in the premium.
(D) European options provide the same early-exercise advantages as American options, making the decision purely based on transaction costs.

May/June 2022

42. When is a put option considered to be out-of-the-money (OTM)?
(A) When the long position will earn a positive payoff if it exercises the option.
(B) When the value of the asset is equal to the strike price.
(C) A put is OTM when the asset price exceeds the strike price, meaning exercise would

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remain perfectly static.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2010

54. An interest rate floor allows a buyer to select an index. Which of the following is NOT typically listed as a popular index for a rate floor?
(A) ARR
(B) Prime rate
(C) Consumer Price Index (CPI)
(D) Commercial paper rate

May/June 2005

55. When trading interest rate caps or floors, a participant selects multiple parameters. Which of the following are included?
I. Notional principal amount upon which interest payments are based.
II. An interest rate benchmark, typically MIBOR, ARR, etc.
III. A cap rate, equivalent to a strike or exercise price on an option.
IV. The period of the agreement, including payment dates and interest rate reset dates.
Which of the above statement(s) is/are correct?
(A) I, II, and IV
(B) I, III, and IV
(C) II, III, and IV
(D) I, II, III, and IV

Oct/Nov 2022

56. Consider the following statements:
I. Put options are zero-sum games as the net P&L is always zero.
II. In a put option, the P&L for the buyer of the put and the P&L for the seller of the put are mirror images of each other.
Which of the above statement(s) is/are correct?
(A) Only I is correct.
(B) Only II is correct.
(C) Both I and II are correct.
(D) Neither I nor II is correct.

May/June 2018

57. Match the payoff scenarios for an interest rate collar buyer (List I) with the outcome (List II):
List I: (Scenario)
P. Index rate $r < r_f$ (floor rate)
Q. Index rate $r_f < r < r_c$
R. Index rate $r > r_c$ (cap rate)
S. Zero cost collar execution
List II: (Outcome)
1. Buyer receives $(N)(r - r_c)(d_t/360)$
2. Buyer pays counterparty $(N)(r_f - r)(d_t/360)$
3. No payments are exchanged
4. Premiums of cap and floor are equal
(A) P-2, Q-3, R-1, S-4
(B) P-1, Q-2, R-3, S-4
(C) P-3, Q-1, R-4, S-2
(D) P-2, Q-4, R-1, S-3

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Oct/Nov 2016

58. Quantitative models like the Black-Scholes model make key assumptions to simplify reality. Which of the following is NOT an assumption of the Black-Scholes model?
(A) Options are American-style and not European-style.
(B) The underlying asset pays no income.
(C) There are no "frictions" such as transaction costs or taxes.
(D) Returns are normally distributed.

May/June 2014

59. Consider the following statements about an interest rate floor:
I. An interest rate floor limits the buyer's interest rate exposure to a minimum rate.
II. Buying a floor is equivalent to the purchase of a call option on an interest rate.
III. If the index rate is below the floor rate, the buyer receives a payment based on the difference.
Which of the above statement(s) is/are correct?
(A) I and II only
(B) II and III only
(C) I and III only
(D) I, II, and III

19. (D) The short call's P&L at expiration is exactly equal to its payoff without factoring in the premium received.
The short call receives an upfront premium for taking on an obligation. At expiration, the profit or loss is determined by combining the payoff with this premium. It is inaccurate to state that the profit and loss is exactly equal to the payoff, as the premium received is a critical component in calculating the final net financial result.

20. (C) I and III only
Forwards do not involve an initial premium, making their payoff and profit identical. However, options require a premium payment at the start. Therefore, a call option profit at expiration is calculated by subtracting the initial premium from the payoff. These differences ensure that the profit and payoff for options are not the same value, unlike forward contracts.

21. (C) $S_T < K$: ITM (In-the-money)
A put option is considered in-the-money when the market price of the underlying asset is lower than the strike price. In this situation, the holder can exercise the right to sell the asset at a price higher than the current market value, resulting in a positive payoff. This condition defines the mathematical profitability of the exercise for the buyer.

22. (B) An agreement giving the purchaser the right to buy the underlying asset at a fixed price at a future time.
A call option is a contractual agreement that provides the buyer the right to acquire an underlying asset. This transaction occurs at a fixed price, known as the strike price, within a specific timeframe. The buyer is not forced to buy, while the seller is obligated to deliver the asset if the buyer chooses to exercise the right.

23. (D) The price of the underlying asset is very close to or equal to the exercise price.
The term at-the-money refers to the specific situation where the market price of the underlying asset is equal to the strike price of the option. In this state, the intrinsic value of the option is zero. Exercising the option would yield no financial gain or loss, excluding the impact of the initial premium paid to enter the contract.

24. (D) The underlying asset price is much higher than the strike price.
An option is described as deep-in-the-money when there is a significant difference between the market price and the strike price. For a call option, this occurs when the underlying asset value is substantially higher than the strike price. This state implies a high probability of exercise and a large intrinsic value for the contract holder at expiration.

25. (B) $S_T \leq K$: c_0
If the market price at expiration is less than or equal to the strike price, the call option will not be exercised. In this case, the short call holder faces no payoff obligation and retains the full premium received at the beginning. This represents the maximum profit potential for the seller of a call option in the market.

26. (A) II, IV, I, III
The development of the Indian derivatives market followed a regulated sequence. Index futures were introduced first in June 2000. These were followed by index options in June 2001. Individual stock options were launched shortly after in July 2001. Finally, single stock futures were introduced in November 2001, completing the initial rollout of these instruments in the domestic financial market.

27. (A) A put option gives the long put the obligation to sell an underlying asset to the short put in the future.
A put option provides the buyer with the right, not the obligation, to sell the underlying asset. Stating that the buyer has an obligation is incorrect. The obligation lies solely with the seller, who must purchase the asset if the buyer chooses to exercise. The strike price and exercise timing follow standard contractual rules for derivative transactions.

28. (A) American options allow exercise anytime until maturity, while European options only allow exercise on the expiration date.
The primary difference between these two styles relates to when the holder can exercise their rights. American-style options offer the

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which derivative instrument provides the most appropriate hedge?
(A) Sell a call option on fuel.
(B) Buy a put option on fuel.
(C) Enter into a short forward contract on fuel.
(D) Buy a call option on fuel.

May/June 2017

67. An investor holds a long put option with a strike price of ₹ 50. At expiration, the stock is trading exactly at ₹ 50. The investor paid a premium of ₹ 3. What is the rational exercise decision and the resulting P&L?
(A) The investor exercises to minimize loss; the resulting P&L is 0.
(B) The investor will not exercise; the resulting P&L is ₹ 3.
(C) The investor exercises (ITM); the resulting P&L is ₹ 47.
(D) The investor is indifferent to exercising (ATM); the resulting P&L is -₹ 3.

Oct/Nov 2005

68. Counterparty A buys a call option from Counterparty B for a premium of ₹ 15, with a strike price of ₹ 100. At expiration, the asset price is ₹ 120. Counterparty A exercises the option. What is the exact monetary loss suffered by Counterparty B, illustrating the zero-sum game principle?
(A) ₹ 5
(B) ₹ 20
(C) ₹ 15
(D) ₹ 35

May/June 2020

69. A trader buys a European call option on a stock with a strike price of ₹ 500, paying a premium of ₹ 30. For the trader to exactly break even at expiration (P&L = 0), what must the price of the underlying stock be?
(A) ₹ 470
(B) ₹ 530
(C) ₹ 500
(D) ₹ 560

Oct/Nov 2015

70. Consider the following summary statements regarding options:
I. Options are agreements that provide one counterparty a right, but not an obligation, to transact in the future.
II. Both long and short call options break even when the underlying asset price is equal to the strike price plus the premium.
III. At expiration, the short put's payoff is the larger of either zero or the strike price minus the underlying asset price.
IV. Put options are zero-sum games, as any profit one of the counterparties receives is exactly equal to the loss the other suffers.
Which of the above statement(s) is/are incorrect?
(A) Only I
(B) Only II
(C) Only III
(D) Only IV

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ANSWERS

1. (D) Option Premium
The fee paid by the buyer to the seller in an options contract represents the cost of acquiring a right without an obligation. This transaction occurs at the initiation of the contract. The seller receives this amount as compensation for taking on the potential obligation to fulfill the contract terms if the buyer chooses to exercise the right later.

2. (C) The combination of both the premium and strike price paid ($S_T = K + c_0$).
For a long call position, the breakeven point occurs when the asset market price compensates for both the strike price and the initial premium paid. At this specific price level, the total cash outflow equals the total cash inflow. Calculating this point involves adding the call premium to the exercise price of the specific option contract being held.

3. (A) II, III, I, IV
The evolution of global options markets followed a specific historical sequence. Customized over-the-counter options on commodities existed first. Equity options launched on the Chicago Board Options Exchange in 1973, followed by currency options on the Philadelphia Stock Exchange in 1982. Interest rate options eventually began trading on the CME, completing this developmental timeline for the international derivative markets.

4. (C) The put premium
In a put option agreement, the long position pays a specific fee to the short position at the start. This payment grants the buyer the right to sell the underlying asset at a predetermined price. The seller accepts this fee to compensate for the risk of being obligated to buy the asset later at a price potentially above market.

5. (B) Premium is the fee paid to the short call in exchange for the long call receiving a right without any obligation.
An options contract is asymmetrical because the buyer holds a right while the seller bears an obligation. To balance this disparity, the buyer pays an upfront fee to the seller. This payment compensates the seller for the risk of potential unfavorable price movements and the lack of choice regarding whether or not the transaction will eventually take place.

6. (B) c_0 (Call premium)
The payoff for a long put is calculated using the strike price and the market price at expiration. It is determined as the difference between these two values, provided it is positive. The call premium is a separate financial component related to call options and does not influence the mathematical calculation of put payoffs at the time of expiration.

7. (B) A contract giving the right, but not the obligation, to buy or sell an asset at a set price for a specific time.
An options contract is a derivative instrument that provides the holder the choice to engage in a transaction. Unlike futures or forwards, there is no requirement for the buyer to execute the trade. This flexibility allows the holder to buy or sell an asset at a pre-specified price within a certain timeframe if conditions are favorable.

8. (B) P-4, Q-1, R-3, S-2
At expiration, a long call holder exercises the right if the market price exceeds the strike price. This results in a profit calculated as the price difference minus the premium. Conversely, if the price is below or equal to the strike, the option is not exercised, and the final loss is simply the amount of the premium paid.

9. (B) ATM occurs when the asset price equals the strike price, resulting in a zero payoff regardless of exercise.
At-the-money status occurs when the market price of the underlying asset equals the strike price. In this scenario, exercising the option results in a zero payoff, as the cost of buying via the option matches the market rate. This concept is unique to options because they

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involve a choice rather than a mandate for the contract counterparties.

10. (C) The buyer would typically do it even when it is not beneficial to them, to recover the premium.
Exercising an option is a strategic decision made by the buyer to utilize their contractual right. For a call, this involves purchasing the asset at the strike price. Rational investors only exercise when it is financially beneficial. They will not exercise a contract that is not beneficial just to recover the paid premium, as that would increase losses.

11. (D) P-3, Q-1, R-4, S-2
The payoff for a long put is zero if the asset price is above the strike price, resulting in a loss equal to the premium. If the price falls below the strike, the payoff is the difference between the strike and market price. Net profit or loss accounts for this payoff minus the initial premium paid at inception.

12. (C) The buyer has the right, but not the obligation, to trade the asset, providing flexibility not found in futures.
The fundamental distinction between options and other derivatives lies in the nature of the obligation. Forwards and futures bind both parties to the transaction at maturity. In contrast, an options contract gives the buyer the choice to trade or let the contract expire, providing asymmetrical risk and reward profiles for the specific counterparties involved in the trade.

13. (A) 0
In this scenario, the market price at expiration is lower than the strike price. The long call holder will not exercise the right to buy because the asset is cheaper in the open market. Since the option is not exercised, the short call position has no obligation to fulfill, resulting in a zero payoff for that specific position at expiration.

14. (C) The short call is also referred to as the "buyer" and the long call as the "seller" or "writer".
In call option terminology, the long position refers to the buyer who holds the right to purchase the asset. The short position is the seller or writer who receives the premium and assumes the potential obligation. Reversing these roles is incorrect because the buyer is never the writer, and the seller is never considered the long position holder.

15. (D) When the strike price is greater than the market price, allowing the buyer to sell the asset at a higher rate.
A put option grants the right to sell an underlying asset. The buyer will logically exercise this right only if the strike price is higher than the current market price. This allows the buyer to sell the asset at a premium relative to the market rate, thereby realizing a positive payoff from the transaction at that time.

16. (A) Real estate physical assets
Options are widely available for various liquid financial instruments, including equities, indices, foreign currencies, and commodities. They are also traded on futures contracts. However, physical real estate assets are generally not used as underlying assets for standardized exchange-traded options due to their illiquid nature, lack of transparency, and unique valuation challenges compared to stocks or commodities.

17. (A) An agreement providing the long put the right to sell an underlying asset to the other counterparty in the future.
A put option is a specific type of financial derivative that empowers the buyer with the choice to sell an asset. This right is exercised at a predetermined strike price before or at expiration. The seller of the put accepts the obligation to buy the asset if the buyer decides to exercise the option during the contract term.

18. (A) The buyer of the option will benefit whenever the price moves in their favour, and this benefit is not shared with the seller.
In an options contract, the buyer and seller have opposing interests. If the price moves in the buyer favor, they retain the full benefit minus the premium paid. The seller does not share in these gains; instead, they face a loss corresponding to the buyer payoff. This represents the nature of the transaction as a transfer of risk.

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(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2025

48. The Black-Scholes-Merton model is used to estimate the value of holding a position in an option. What specific volatility input does this pricing equation utilize?
(A) The volatility of the returns of the underlying asset on the expiration date.
(B) The volatility of the returns of the underlying asset on the valuation date.
(C) The volatility of the continuous compounded risk-free interest rate.
(D) The subjective volatility forecasted by the counterparties independently.

May/June 2012

49. A corporate entity buys a one-year interest rate cap starting January 15. The interest rate is reset semi-annually on July 15. The first period of a cap agreement typically excludes a payment. If the six-month MIBOR drops to 4.5% on July 15, and the cap rate is 5%, what will the buyer receive on the following January 15 payment date?
(A) No payment, and the buyer loses the premium paid for the cap.
(B) A payment calculated based on the 0.5% differential.
(C) A full refund of the premium paid.
(D) No payment, but the seller returns the cap.

Oct/Nov 2014

50. Identify the incorrect pair related to a floating-rate loan's provided details:
(A) The reference rate : Base benchmark for the loan
(B) The premium : Added to the reference rate in basis points reflecting creditworthiness
(C) Reset period: A static date when the loan is fully paid off regardless of interest rate volatility.
(D) Cap rate : A stipulated maximum rate acting as a strike or exercise price on an option

May/June 2019

51. Consider the following statements about options:
I. An options contract conveys the right to buy or sell a specified asset at a fixed price for a fixed length of time.
II. Both long and short call options break even when the underlying asset price is equal to the strike price plus the premium.
III. Call options are zero-sum games.
IV. The short call's payoff at expiration is the larger of either zero or the strike price minus the underlying asset price.
Which of the above statement(s) is/are correct?
(A) I, II, and III
(B) II, III, and IV
(C) I, III, and IV
(D) I, II, and IV

Oct/Nov 2006

52. The following question consists of two statements, one labeled Assertion (A) and the other labeled Reason (R). Select the correct answer using the codes given below:
Assertion (A): The intrinsic value of a put option is zero when the underlying asset price is greater than or equal to the strike price.
Reason (R): A put option only has intrinsic value when the underlying asset price is less than the strike price.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2021

53. The following question consists of two statements, one labeled Assertion (A) and the other labeled Reason (R). Select the correct answer using the codes given below:
Assertion (A): Under the Black-Scholes model, the underlying asset volatility is assumed to be known and constant over the life of the option.
Reason (R): Real-world market frictions and transaction costs strictly regulate volatility to

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flexibility to exercise at any point until the expiration date. In contrast, European-style options restrict the exercise of the right to the expiration date itself. This timing difference is the fundamental characteristic distinguishing the two styles in the market.

29. (A) I, II, and III
Options are zero-sum games where the profit of one party exactly equals the loss of the other. The net profit across both positions is always zero. If the option is not exercised, the buyer loses the premium while the seller gains it. The formula for profit and loss reflects this inverse relationship between the counterparties in every scenario.

30. (B) Only II is correct.
The payoff for a long call is calculated as the maximum of zero or the difference between the market price and the strike price. A rational buyer will only exercise if the market price exceeds the strike price to gain a positive value. Therefore, the mathematical representation of the payoff accurately captures the financial incentive for exercise at expiration.

31. (C) ₹ 8
For a short put, the profit or loss is determined by the exercise decision of the buyer. Since the market price of 125 is higher than the strike price of 115, the buyer will not exercise the option. Consequently, the seller has no payoff obligation and keeps the entire 8 premium as profit, representing the maximum potential gain.

32. (B) ₹ 2,520.55
To calculate the payment, the difference between the reset rate and the cap rate is multiplied by the notional principal and the day-count fraction. Here, the rate difference is 0.5 percent. Multiplying one million by 0.005 and then by the ratio of 184 to 365 results in the specific amount owed by the seller to the buyer.

33. (B) Exercise decision : Option will not be exercised
When the market price is below the strike price at expiration, a put option is in-the-money. The holder will logically exercise their right to sell at the higher strike price. Therefore, it is incorrect to suggest the option will not be exercised in this scenario. The seller must fulfill the obligation, resulting in a negative payoff for them.

34. (A) I, II, III, and V
Collars are used to manage interest rate risk by combining caps and floors. A normal collar involves buying a cap and selling a floor, while a reverse collar involves buying a floor and selling a cap. Banks use reverse collars to protect against falling rates. These instruments are primarily traded in over-the-counter markets based on specific institutional hedging needs.

35. (A) P-4, Q-2, R-1, S-3
The Black-Scholes model uses specific variables to calculate option values. These include the risk-free interest rate on the valuation date and the specific dates for valuation and expiration. Additionally, the standard normal cumulative distribution function is applied to determine probabilities. Correctly identifying these notations is essential for applying the formula accurately to price European-style call and put options.

36. (A) Buy a reverse collar (buy an interest rate floor and sell an interest rate cap).
A bank concerned about falling interest rates on its floating-rate loans needs a minimum guaranteed return. Buying an interest rate floor provides this protection. To offset the premium cost, the bank can simultaneously sell an interest rate cap. This combined strategy of buying a floor and selling a cap is known as a reverse interest rate collar.

37. (A) -₹ 7
In this case, the market price of 133 is higher than the strike price of 122. The long put holder will not exercise the option because selling at the market price is more profitable than selling at the strike price. Since the option expires worthless, the investor total loss is simply the initial premium paid for the contract.

38. (B) Only II is correct.
An interest rate cap functions as a financial insurance policy against rising rates. It is mathematically equivalent to holding a series

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of call options on interest rates. While it limits the buyer exposure to a maximum rate, it does not limit exposure to a minimum rate; that is the function of an interest rate floor.

39. (D) P-4, Q-2, R-3, S-1
A multi-period interest rate floor is viewed as a collection of European-style put options on a sequence of forward rate agreements. The payment formula calculates the difference between the floor rate and the index. Buying an in-the-money floor requires a high premium. Selling a forward rate agreement provides a payoff structure similar to receiving payments when interest rates fall.

40. (D) $d_1 = \dfrac{\ln(S_t/K) + (r_t + \sigma_t^2/2)(T-t)}{\sigma_t\sqrt{T-t}}$
The d1 term in the Black-Scholes-Merton model is a critical component for pricing options. It is calculated by taking the natural logarithm of the ratio of the asset price to the strike price. This is then added to the risk-free rate plus half the variance, multiplied by the time to maturity, and divided by the total volatility of the asset.

41. (B) Put options are exercised early if the benefit of receiving the strike price outweighs the loss of time value.
Early exercise of American options depends on specific financial factors. For put options, it becomes rational if the immediate benefit of receiving the strike price exceeds the remaining time value of the option. For call options on non-dividend paying stocks, early exercise is generally not optimal. Investors must weigh the interest earned on the strike against the potential gains.

42. (C) A put is OTM when the asset price exceeds the strike price, meaning exercise would result in a loss.
A put option is out-of-the-money when the market price of the underlying asset is greater than the strike price. In this situation, the holder has no incentive to exercise the right to sell at the lower strike price. Exercising would lead to a financial loss compared to selling the asset directly in the open market at that time.

43. (C) Assertion (A) is true, but Reason (R) is false.
If the market index stays below the cap rate, the buyer of a cap receives no payment and the premium is lost. This is because a cap is an option, providing a right but not an obligation. The buyer is never obligated to pay the seller if rates fall, making the reason provided regarding payment obligations false.

44. (A) I and II only
Interest rate calls and puts are financial contracts that allow participants to manage rate risks and are frequently traded on regulated exchanges. Conversely, more complex structures like interest rate caps, floors, and collars are typically customized and traded in over-the-counter markets. It is incorrect to state that these multi-period instruments are usually traded on exchanges rather than OTC.

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45. (C) The strategy limits any potential gains from falling interest rates below the floor level.
A zero-cost collar eliminates the upfront premium by selling a floor to fund the purchase of a cap. However, this strategy limits the borrower ability to benefit from falling interest rates. If rates drop below the floor level, the borrower must pay the difference to the counterparty, effectively setting a minimum limit on their effective borrowing rate.

46. (A) I, II, III, and IV
The seller of a put is obligated to buy the asset if the buyer exercises. This occurs when the market price is below the strike price, leading to a negative payoff for the seller. When the price is above the strike, the option expires worthless, and the seller profits by the amount of the premium received at initiation.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
A zero-cost collar is a popular hedging strategy for borrowers. It works by aligning the premium paid for an interest rate cap with the premium received from selling an interest rate floor. This results in no net initial cash outflow while still providing a range of protection against interest rate movements, as accurately described by the assertion and reason.

48. (B) The volatility of the returns of the underlying asset on the valuation date.
The Black-Scholes model requires an estimate of the future volatility of the underlying asset returns. Specifically, it uses the volatility measured or expected on the valuation date for the period until expiration. This parameter represents the standard deviation of the asset continuously compounded returns and is a crucial factor in determining the theoretical fair value of the option.

49. (A) No payment, and the buyer loses the premium paid for the cap.
In an interest rate cap, a payment is triggered only if the reference index exceeds the cap rate on the reset date. If the MIBOR rate falls below the cap rate, the condition for exercise is not met. Consequently, the buyer receives nothing for that period, and the premium spent on the protection is not recovered by the buyer.

50. (C) Reset period: A static date when the loan is fully paid off regardless of interest rate volatility.
A floating-rate loan involves a reference rate and a credit premium that determines the periodic interest cost. The reset period defines the frequency at which the interest rate is updated based on current market conditions. It is not a static date for full loan repayment, as the loan remains active with varying rates throughout its term until maturity.

51. (A) I, II, and III
Options provide the right to buy or sell assets at fixed prices. They are zero-sum games where the total profit and loss among participants equals zero. For a call option, the breakeven point for both parties is the strike price plus the premium. The short put payoff is not the larger of zero or strike minus market price.

52. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
The intrinsic value of a put option represents the immediate profit if the option were exercised. This occurs only when the market price is below the strike price. If the market price is equal to or higher than the strike, there is no benefit to exercising, and the intrinsic value is zero. Both the assertion and reason correctly reflect this.

53. (C) Assertion (A) is true, but Reason (R) is false.
The Black-Scholes model simplifies market dynamics by assuming that the volatility of the underlying asset remains constant until the option expires. While this assumption is necessary for the model formula, real-world markets do not follow this rule, as volatility fluctuates. Therefore, the reason provided regarding static volatility via frictions is incorrect in a financial context for these models.

54. (C) Consumer Price Index (CPI)
Interest rate floors are benchmarked against specific interest rate indices such as the prime rate, commercial paper rates, or interbank offered rates like MIBOR. The Consumer Price Index is a measure of inflation rather than a direct interest rate benchmark. Therefore, it is not typically used as the underlying index for standard interest rate derivative contracts like floors or caps.

55. (D) I, II, III, and IV
Trading these interest rate derivatives involves selecting several critical variables. These include the notional principal for calculations, the specific benchmark rate like MIBOR, and the strike rate known as the cap or floor rate. Additionally, the parties must agree on the contract duration, reset dates, and payment schedules to ensure the agreement is properly structured for effective risk management.

56. (C) Both I and II are correct.
In a put option, every gain for the buyer is a loss for the seller, making it a zero-sum game. Consequently, their profit and loss profiles are mirror images across the horizontal axis. Both statements correctly describe the fundamental financial relationship between the long and short positions in an options contract, reflecting the balanced nature of these specific derivative markets.

57. (A) P-2, Q-3, R-1, S-4
A collar buyer receives a payment if the index exceeds the cap rate. If the index falls below the floor rate, the buyer must pay the

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higher than long-term yield difference
(B) Yield compression - Difference in borrowing rates across different currencies
(C) Long-term yield difference - Attributed to higher risk in lending to lower credit rating
(D) Duration gap - Difference between swap rate and market rate

May/June 2006

32. Consider the following statements about Interest Rate Swaps:
I They involve an exchange of a stream of interest payments for a notional principal amount.
II The most commonly used floating rate benchmark is ARR.
III The buyer assumes the short position and receives fixed.
IV Swap facilitators receive a commission for their services.
V The NPV of the two streams of payments must be zero at the end of the transaction.
(A) (I), (II), and (IV)
(B) (I), (II), (III), and (IV)
(C) (II), (III), and (V)
(D) (I), (III), (IV), and (V)

Oct/Nov 2017

33. Match the swaption outcomes in List I to the corresponding scenarios in List II, assuming the buyer anticipates a rate increase.
List I: (Outcome)
P. Let option expire, borrow at market rate
Q. Lose premium paid, option expires
R. Exercise option, cost of funding = Swap rate + Premium
S. Exercise option, gain difference between market rate and swap rate
List II: (Scenario)
1. Interest rate increases and project is successful.
2. Interest rate decreases and project is unsuccessful.
3. Interest rate increases and project is unsuccessful.
4. Interest rate decreases and project is successful.
(A) P-4, Q-2, R-1, S-3
(B) P-2, Q-4, R-3, S-1
(C) P-4, Q-1, R-2, S-3
(D) P-1, Q-3, R-4, S-2

May/June 2008

34. Evaluate the following statements and determine their accuracy:
Assertion (A): Entering into a long interest rate swap position is advantageous if one has the view that the reference benchmark rate will decrease.
Reason (R): The buyer of the IRS agrees to periodically receive a floating rate and pay a fixed rate.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2013

35. Examine the following statements and determine their accuracy:
I A market participant should enter into a long interest rate swap (buy) if they have the view that the reference rate (like MIBOR) will decrease.
II The short interest rate swap position benefits if the reference rate decreases.
Which of the following is correct?
(A) Both (I) and (II) are true.
(B) Both (I) and (II) are false.
(C) Statement (I) is true, but Statement (II) is false.
(D) Statement (I) is false, but Statement (II) is true.

May/June 2015

36. Based on the scenario in Question 57, what is the calculated floating rate payment for the first half-year?
(A) ₹ 275,770
(B) ₹ 250,700
(C) ₹ 300,840
(D) ₹ 224,370

Oct/Nov 2012

37. Match the swap participants in List I with their corresponding descriptions in List II.

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67. (D) The investor is indifferent to exercising (ATM); the resulting P&L is -₹ 3.
Since the market price equals the strike price, the option is at-the-money. The payoff from exercising is zero. Regardless of whether the investor exercises or not, the financial outcome is the same. The net loss for the investor is the initial 3 premium paid for the option. The investor is therefore indifferent to the exercise decision here.

68. (A) ₹ 5
The long call holder payoff is 20, calculated as the market price of 120 minus the strike price of 100. The long holder net profit is 5 after subtracting the 15 premium. Since options are zero-sum games, the short call loss must exactly equal the long call gain. Therefore, the seller suffers a net loss of 5.

69. (B) ₹ 530
To reach the breakeven point for a long call, the underlying asset price must rise enough to cover both the strike price and the premium paid. Adding the strike price of 500 to the premium of 30 gives a total of 530. At this price level, the payoff from exercise exactly offsets the cost of the premium.

70. (C) Only III
Most of the summary statements correctly describe the nature of options as rights without obligations and zero-sum games. However, the statement regarding the short put payoff is incorrect. The short put payoff is calculated as the minimum of zero or the market price minus the strike price. The larger value of zero or strike minus price describes the long put.

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based on the prevailing ARR over time.
(B) The fixed rate is recalculated on an annual basis using current market conditions.
(C) The fixed rate is set at initiation and remains constant throughout the swap.
(D) The fixed rate is paid out as a single lump sum only at the final maturity date.

Oct/Nov 2018

15. When the Alternative Reference Rate (ARR) changes after the initiation of an interest rate swap, what is the best description of the resulting impact on the counterparties?
(A) The swap's value stays at zero for both parties as it was deemed fair at contract initiation.
(B) Both counterparties will experience an equal and simultaneous increase in their asset values.
(C) The counterparty in the short position must pay an upfront premium to the long position holder.
(D) The swap becomes an asset for the benefiting party and a liability for the harmed counterparty.

May/June 2023

16. What is the monetary figure used as a part of the calculation to determine the payment amounts in a swap contract known as?
(A) Notional Principal
(B) Swap Premium
(C) Strike Price
(D) Economic Value

Oct/Nov 2009

17. All of the following are benchmarks commonly referred to in India for floating rates EXCEPT:
(A) Federal Funds Rate
(B) MIBOR
(C) Treasury Bill YTM
(D) Government Securities YTM

May/June 2016

18. By convention, what are the cash flow obligations of the buyer (long position) in an Interest Rate Swap?
(A) Agrees to periodically receive a floating rate and pay a fixed rate.
(B) Agrees to periodically receive a fixed rate and pay a floating rate.
(C) Agrees to pay both a fixed rate and a floating rate.
(D) Agrees to receive both a fixed rate and a floating rate.

Oct/Nov 2019

19. Which of the following statements regarding the key points of swaps is INCORRECT?
(A) Swaps are over-the-counter contracts between private parties.
(B) The swap rate is the rate at which the party with a fixed-interest-rate obligation pays the party with a floating-rate obligation.
(C) A forward swap is a contract to enter into a swap at a future time.
(D) Swap contracts generally have a shorter maturity compared to forwards and futures.

May/June 2009

20. How do banks utilize interest rate swaps for GAP management?
(A) By converting floating-rate debt into long-term fixed rates to match liability and asset durations.
(B) By converting long-term fixed-rate liabilities into short-term assets to reduce the duration gap.
(C) By selling swaptions to immediately liquidate long-duration assets and increase current liquidity.
(D) By exchanging their common equity holdings for floating-rate debt instruments to alter capital.

Oct/Nov 2011

21. Consider the following steps regarding the calculation of the floating leg payment in an interest rate swap. Arrange them in the correct sequence:
I Calculate the floating payment.
II Calculate the quarterly/half-yearly floating rate.
III Calculate the floating rate accrual factor.
(A) (I), (II), (III)
(B) (III), (II), (I)
(C) (II), (III), (I)
(D) (III), (I), (II)

NODIA

May/June 2010

22. What is the day count basis convention followed for a rupee interest rate swap?
(A) Actual/360

cash flow streams according to a pre-arranged formula.

(C) A standard contract giving the buyer the right, but not the obligation, to purchase an asset.

(D) A formal agreement to issue equity shares in direct exchange for specific physical commodities.

May/June 2021

8. Which of the following correctly outlines one of the primary uses of a swaption?

(A) To guarantee an immediate risk-free arbitrage opportunity.

(B) To obtain access to a swap when borrowers are uncertain of the funding that will be required.

(C) To force a counterparty to terminate a swap contract at a loss.

(D) To convert a commodity swap into an equity swap without paying a premium.

Oct/Nov 2010

9. A swaption can be used by a buyer for all of the following purposes EXCEPT:

(A) To bring a swap into place when hedging becomes necessary.

(B) To eliminate the need for paying an upfront premium.

(C) To remove an existing swap when it becomes unattractive.

(D) To enhance the yield on an underlying position by selling a swaption.

May/June 2005

10. What does it indicate when there is no premium paid or received by either the long or short position at the initiation of an interest rate swap?

(A) The swap contract is fully guaranteed and cleared by a central exchange.

(B) The swap has an infinite maturity date with no specified termination period.

(C) The swap is designed to have zero net value for both parties at initiation.

(D) The swap is structured to produce equal cash flows throughout its entire life.

Oct/Nov 2022

11. Consider the following steps involved in ensuring an interest rate swap has zero value at initiation. Arrange them in the correct sequence:

I All future interest payments to be made during the life of the bond are estimated.

II A fixed rate is agreed upon that is perceived as fair to both counterparties.

III Estimated future cash flows are discounted using the expected change in benchmark rate.

IV The NPV of the two streams of interest payments is equated at the beginning of the transaction.

(A) (II), (I), (III), (IV)

(B) (I), (III), (IV), (II)

(C) (IV), (II), (I), (III)

(D) (I), (II), (III), (IV)

May/June 2018

12. What is the minimum notional principal amount for which market makers in India stand committed to their two-way quote in a swap transaction?

(A) ₹ 1 crore

(B) ₹ 2 crores

(C) ₹ 5 crores

(D) ₹ 10 crores

Oct/Nov 2016

13. In a scenario where a corporation buys a swaption for a project whose funding is uncertain, which of the following outcomes is INCORRECT?

(A) If the interest rate decreases and the project is unsuccessful, the corporation will receive a refund of the premium paid.

(B) If the interest rate increases and the project is successful, the corporation will exercise the option.

(C) If the interest rate decreases and the project is successful, the corporation lets the option expire.

(D) If the interest rate increases and the project is unsuccessful, the corporation will exercise the option to gain the difference between the higher market rate and the swap rate.

NODIA

May/June 2014

14. Which of the following statements accurately describes the fixed rate in an interest rate swap?

(A) The fixed rate fluctuates periodically

counterparty. No money is exchanged when the index remains between these two rates. In a zero-cost collar, the premiums for the cap and floor are structured to be exactly equal at initiation of the contract.

58. (A) Options are American-style and not European-style.
The Black-Scholes model is specifically designed for European-style options, which can only be exercised at maturity. It assumes no transaction costs, no taxes, and that the underlying asset provides no income during the life of the option. It also assumes that asset returns follow a normal distribution. Stating that it assumes American-style options is incorrect as those require different valuation methods.

59. (C) I and III only
An interest rate floor protects the buyer against falling rates by setting a minimum level. It is equivalent to a series of put options, not call options. If the market index falls below the specified floor rate, the seller pays the buyer the difference. This makes it an effective tool for investors seeking to guarantee a minimum return on floating-rate investments.

60. (B) A loan where the rate fluctuates based on a market benchmark, often set as a reference rate plus a specific premium.
Floating-rate loans are debt instruments where the interest rate changes periodically. These changes are tied to a market benchmark, such as MIBOR, plus an additional spread based on the borrower credit risk. This structure exposes both the borrower and lender to interest rate volatility, which is why caps, floors, and collars are often used to manage these specific financial risks.

61. (C) Do not exercise the option to avoid a negative payoff; the option is OTM.
With the market price at 290 and a strike price of 300, a call option is out-of-the-money. Exercising would mean buying the asset for more than its market value, leading to an immediate loss. A rational investor will let the option expire worthless. This avoids any further financial loss beyond the initial premium already paid to the seller.

62. (A) Buy an index put option.
A portfolio manager seeking protection against a market decline while maintaining upside potential should buy a put option. This strategy, often called a protective put, establishes a floor price for the portfolio. If the market crashes, the put option provides a payoff that offsets the losses. If the market rises, the manager only loses the premium paid for the option.

63. (A) I, II, III, and V
Moneyness indicates the potential for exercise based on the relationship between the strike and market prices. A call is in-the-money if the market price is higher than the strike. A put is in-the-money if the market price is lower. However, at-the-money options do not earn high payoffs; they have zero intrinsic value and result in zero payoffs.

64. (C) Caps limit maximum borrowing costs while allowing users to benefit from lower rates if the market drops.
Using a cap instead of a fixed-rate loan or forward contract offers asymmetric protection. The cap provides a ceiling on borrowing costs, protecting the borrower from rising interest rates. Crucially, if interest rates fall, the borrower is not locked into a high rate and can benefit from lower market rates. This flexibility is the primary advantage for the corporate borrower here.

65. (B) ₹ 150
The speculator payoff is calculated as the strike price of 1,000 minus the market price of 800, which equals 200. To find the net profit, the initial premium of 50 must be subtracted from this payoff. This results in a final net profit of 150. The drop in price below the strike price made the exercise profitable.

66. (D) Buy a call option on fuel.
An airline wanting to cap its fuel costs without an obligation to buy at high prices if the market drops should buy a call option. This derivative provides the right to buy fuel at a set strike price. If prices surge, the option is exercised to save money. If prices drop, the airline lets the option expire.

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(B) Actual/365
(C) 30/360
(D) Actual/Actual

Oct/Nov 2024

23. Which term describes the phenomenon where the difference between borrowing rates for two different borrowers is higher in the long-term market than in the short-term market?
(A) Duration Gap
(B) Yield Compression
(C) Notional Advantage
(D) Rate Disparity

May/June 2017

24. Which of the following is NOT a characteristic of an interest rate swap?
(A) The fixed rate does not change during the life of the swap.
(B) The maturity of the swap is referred to as its tenor.
(C) Common interest rate swap tenors are 5- and 10-year tenors.
(D) The floating rate is fixed at initiation and remains constant.

Oct/Nov 2005

25. Which of the following statements regarding swap intermediaries is INCORRECT?
(A) Swap brokers bring swap counterparties together to arrange a swap.
(B) Swap dealers act only as brokers and never enter into swaps on their own behalf.
(C) Swap facilitators help clients find ways to alter or avoid unwanted risks.
(D) Swap charges are nominal in relation to the risk that the swap is able to manage.

May/June 2020

26. Which of the following defines a swaption?
(A) An agreement to immediately exchange a floating rate for a fixed rate.
(B) A futures contract based on an underlying swap agreement.
(C) A standardized contract to cancel an existing swap on an exchange.
(D) An option to enter into a swap at a future date.

Oct/Nov 2021

27. A corporation tenders for a large project with uncertain funding but anticipates that interest rates may increase. What is the best course of action to manage this risk without risking large speculative losses if the project fails?
(A) Purchase a swaption paying a premium upfront.
(B) Enter into a standard fixed-for-floating interest rate swap immediately.
(C) Borrow the total projected funds immediately at the short-term market rate.
(D) Sell an equity swap to raise the required capital.

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May/June 2013

28. How is the value of an interest rate swap classified for a counterparty whose position benefits from a change in the Alternative Reference Rate (ARR) after initiation?
(A) It becomes an asset with a positive value.
(B) It remains at zero value.
(C) It becomes a liability with a negative value.
(D) It transforms into a swaption.

Oct/Nov 2015

29. All of the following are mentioned as commonly used types of swaps EXCEPT:
(A) Interest Rate Swaps
(B) Currency Swaps
(C) Real Estate Swaps
(D) Equity Swaps

May/June 2024

30. Which of the following correctly describes a Commodity Swap?
(A) One party agrees to exchange payments based on one currency with another party for payments based on another currency.
(B) One leg of the swap involves cash flows based on the performance of a stock index, while the other is based on a floating interest rate.
(C) One party agrees to exchange interest payments based on a fixed rate with another party for interest payments based on a floating rate.
(D) The floating market price is exchanged for a fixed price over a certain period.

Oct/Nov 2008

31. Which of the following pairs accurately reflects the concept of yield compression?
(A) Short-term yield difference - Typically

CHAPTER 38
SWAP

Oct/Nov 2015

1. In which year did a bank execute a currency swap to swap cash flows denominated in Swiss francs and Deutschmarks, marking significant growth in the swap market?
(A) 1971
(B) 1991
(C) 1999
(D) 1981

May/June 2012

2. Which of the following statements about comparative advantage in swaps is INCORRECT?
(A) A borrower's credit rating directly influences the borrowing rate set for them in the market.
(B) Yield compression contributes to the existence of comparative advantage.
(C) The difference in borrowing rates for two different borrowers is typically higher in the short-term market than in the long-term market.
(D) Swaps allow two parties to share the comparative advantage to achieve a lower interest rate.

Oct/Nov 2007

3. Who among the following are described as specialists in the swap market that help clients find ways to alter or avoid unwanted risks by designing swaps?
(A) Swap Brokers
(B) Swap Dealers
(C) Swap Facilitators
(D) Arbitrageurs

May/June 2025

4. What is the most appropriate reason for the larger difference in borrowing rates between two different borrowers in the long-term market compared to the short-term market?
(A) Long-term markets have higher liquidity which naturally widens the spread.
(B) Short-term markets are heavily regulated, standardizing the rates for all participants.
(C) Lenders face higher risk when lending to a party with a lower credit rating over a longer term.
(D) Swap dealers intentionally manipulate long-term rates to create comparative advantage.

Oct/Nov 2014

5. According to the principles of swap valuation, how can interest rate swaps and currency swaps be conceptually valued?
(A) As a single European option expiring at maturity.
(B) As a series of forward contracts.
(C) As a constantly adjusting equity index.
(D) As a portfolio of short-term zero-coupon bonds.

May/June 2019

6. Under comparative advantage, if Company B has a better credit rating than Company A in both fixed and floating markets, what is the most appropriate reason they enter into a swap arrangement?
(A) Because Company B lacks the legal standing to borrow independently within the floating market.
(B) Because Company B holds a comparative advantage in one market, allowing both to share gains.
(C) Because Company A is legally restricted from accessing fixed-rate borrowing due to internal policy.
(D) Because the central bank requires highly rated companies to subsidize lower-rated firms via swaps.

Oct/Nov 2006

7. Which of the following best defines a swap?
(A) An exchange-traded agreement to buy or sell an asset at a predetermined price at a future date.
(B) A private agreement to exchange future

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List I: (Participant)
P. Buyer
Q. Seller
R. Swap Facilitator
S. Swap Dealer
List II: (Description)
1. Acts as a broker and also enters into swaps on their own behalf.
2. Assumes the short interest rate swap position.
3. Financial engineers who design swaps to solve client problems.
4. Agrees to periodically receive a floating rate and pay a fixed rate.

(A) P-4, Q-2, R-3, S-1
(B) P-2, Q-4, R-1, S-3
(C) P-4, Q-3, R-2, S-1
(D) P-1, Q-2, R-4, S-3

May/June 2011

38. Consider the following statements about a Swaption where the buyer anticipates a rate increase:

I The buyer pays a premium upfront to lock in a certain funding cost.
II If rates decrease and the project succeeds, the cost of funding equals Swap rate + Option premium.
III If rates increase and the project fails, the buyer will still exercise the option to gain the difference between the market rate and swap rate.
IV A swaption can also be used to remove an existing swap.

Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), (III), and (IV)

Oct/Nov 2020

39. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.

Assertion (A): An interest rate swap is designed to have zero value for both counterparties at initiation.

Reason (R): A fixed rate is set such that it is perceived as fair to both counterparties, ensuring neither's position is an asset nor a liability at initiation.

(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

NODIA

May/June 2022

40. Which of the following pairs regarding swap characteristics is INCORRECTLY matched?
(A) Tenor - Maturity of the swap
(B) Interest Rate Swap - Floating rate fluctuates over time
(C) Premium at initiation - Designed to have zero value for both counterparties
(D) Swap contracts - Exchange-traded agreements

Oct/Nov 2023

41. Based on the calculations from the previous questions, what is the net cash flow received by the short position for the first half-year?
(A) ₹ 25,070
(B) (₹ 25,070)
(C) ₹ 24,930
(D) (₹ 24,930)

May/June 2007

42. In an Interest Rate Swap where the Fixed Rate is 5% and the Floating Rate is MIBOR + 1%, match the condition in List I with the outcome for Counterparty A (Buyer/Long) in List II.
List I: (Condition)
P. MIBOR $> 5\%$
Q. MIBOR $< 5\%$
R. MIBOR $= 5\%$
S. Expectation of MIBOR decreasing
List II: (Outcome)
1. Receives at less rate than he pays.
2. Action should be to enter into a short position (sell).
3. Receives at higher rate than he pays.
4. Receives at same rate as he pays.

(A) P-3, Q-1, R-4, S-2

grants the holder the right, but not the legal obligation, to enter into a specific interest rate swap agreement on a predetermined future date. This provides flexibility, as the holder can choose to exercise the option only if market conditions are favorable at maturity.

27. (A) Purchase a swaption paying a premium upfront.
When funding requirements are uncertain, a corporation can manage interest rate risk by purchasing a swaption. This strategy allows the firm to lock in a maximum swap rate while maintaining the flexibility to walk away if the project is not funded. Although an upfront premium is required, it prevents the firm from being committed to a potentially disadvantageous long-term swap.

28. (A) It becomes an asset with a positive value.
After a swap is initiated, changes in market interest rates impact the present value of the future cash flows. For a counterparty whose position benefits from these changes, the expected receipts now outweigh the expected payments on a discounted basis. Consequently, the swap contract gains positive economic value for that party, and it is recorded as an asset on their balance sheet.

29. (C) Real Estate Swaps
The financial markets utilize several major categories of swaps, including interest rate, currency, commodity, and equity swaps. These instruments allow for the exchange of various types of financial returns or obligations. However, real estate swaps are not considered a standard or commonly traded category in the derivative markets, as property transactions typically involve direct transfers or specific securitized instruments.

30. (D) The floating market price is exchanged for a fixed price over a certain period.
A commodity swap is a financial arrangement used primarily for hedging price volatility in raw materials. In this contract, one party agrees to pay a fixed price for a specific commodity over a set period, while the other party pays the prevailing market or floating price. This allows producers and consumers to stabilize their costs or revenues against price swings.

31. (C) Long-term yield difference - Attributed to higher risk in lending to lower credit rating
Yield compression and rate differences are fundamentally linked to credit risk perceptions over time. In long-term markets, the gap between the borrowing rates for different credit tiers is typically wider because lenders face greater uncertainty. This provides the basis for comparative advantage, where entities with different credit profiles can swap their borrowing benefits to achieve lower overall costs for both.

32. (A) (I), (II), and (IV)
Interest rate swaps involve exchanging interest payment streams based on a notional principal. In modern markets, the floating leg is typically linked to an Alternative Reference Rate. Furthermore, swap facilitators earn commissions for designing these complex solutions. It is important to note that the buyer assumes the long position, and the net present value must be zero at initiation, not maturity.

33. (A) P-4, Q-2, R-1, S-3
Swaption outcomes depend on market rates and project success. If rates decrease and a project succeeds, the buyer lets the option expire to borrow cheaper. If rates decrease and the project fails, the premium is lost. If rates increase and the project succeeds, the option is exercised for funding. If rates increase and the project fails, the option is exercised for profit.

34. (D) Assertion (A) is false, but Reason (R) is true.
The buyer of an interest rate swap receives a floating rate and pays a fixed rate. Therefore, this position is advantageous only if market interest rates increase, leading to higher floating receipts. If the benchmark rate decreases, the buyer continues to pay the same fixed rate while receiving smaller floating payments, making the assertion that a rate decrease is advantageous false.

35. (D) Statement (I) is false, but Statement (II) is true.
A long position in an interest rate swap involves paying fixed and receiving floating, meaning it benefits from rising rates. Conversely, the short position involves paying floating and receiving

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(C) Swaption use - Remove an existing swap when it becomes unattractive
(D) Swaption use - Obtain access to a swap when funding requirements are uncertain

May/June 2012

49. Consider the mathematical properties of an Interest Rate Swap (IRS) calculation:
I The floating rate payment for a half-year is calculated using an accrual factor of 183/365.
II The fixed rate is applied strictly on an annual basis without adjustment for days.
III Net cash flow received by the long position is the fixed rate leg payment minus the floating rate leg payment.
IV The second half-year typically accounts for 182 days.
V The total notional principal determines the scale of the periodic payments.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (V)
(B) (I), (IV), and (V)
(C) (II), (III), and (IV)
(D) (I), (III), (IV), and (V)

Oct/Nov 2014

50. Consider the following statements about calculating floating leg payments:
I The floating rate accrual factor is calculated as Days in the period divided by 365.
II The half-yearly rate is calculated by multiplying the annualized floating rate by the floating rate accrual factor.
III The floating rate payment is the product of the half-yearly interest rate and the notional principal.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) All (I), (II), and (III)

May/June 2019

51. Assuming the second half-year has 182 days, what is the fixed rate payment for the second half-year in the scenario from Question 57?
(A) ₹ 250,700
(B) ₹ 275,770
(C) ₹ 224,370
(D) ₹ 249,300

Oct/Nov 2006

52. Which of the following pairs concerning swap positions is correctly matched?
(A) Buyer - Short interest rate swap position
(B) Seller - Assumes the long position in the contract
(C) Seller - Receives a floating rate and pays a floating rate
(D) Buyer - Receives a floating rate and pays a fixed rate

May/June 2021

53. Evaluate the following statements regarding comparative advantage:
I If Company A and Company B share a total gain of 30 points equally, each party will gain 15 points in their borrowing costs.
II The total gain is the difference between the comparative advantages in the fixed and floating rate markets.
Which of the following is correct?
(A) Both (I) and (II) are true.
(B) Both (I) and (II) are false.
(C) Statement (I) is true, but Statement (II) is false.
(D) Statement (I) is false, but Statement (II) is true.

Oct/Nov 2010

54. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.
Assertion (A): The difference in borrowing rates for two different borrowers is typically higher in the short-term market than in the long-term market.
Reason (R): Yield compression refers to the difference between borrowing rates in the long-term and short-term markets, driven by the higher risk of lending to a lower-rated party over the long term.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct

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(B) P-1, Q-3, R-2, S-4
(C) P-3, Q-4, R-1, S-2
(D) P-4, Q-1, R-3, S-2

Oct/Nov 2025

43. Consider the following statements regarding the core principles of swaps:
I Swaps were developed for the purposes of hedging risks.
II Swap contracts generally have a shorter maturity than forwards and futures.
III The swap rate is the rate at which the party with a fixed-rate obligation pays the party with a floating-rate obligation.
IV A forward swap is a contract to enter into a swap at a future time.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (IV)
(B) (I), (III), and (IV)
(C) (II), (III), and (IV)
(D) (I), (II), and (III)

Oct/Nov 2009

44. Consider the following statements about Swaps:
I Swaps are private, OTC agreements.
II At least one of the cash flows in a swap must be determined on the basis of an uncertain variable at the time of the contract.
III No exchange exists for swap contracts.
Which of the above statement(s) is/are correct?
(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) All (I), (II), and (III)

May/June 2023

45. Based on the scenario in Question 57, what is the annualized floating rate applicable for the first half-year?
(A) 4.5%
(B) 5.0%
(C) 5.5%
(D) 6.0%

Oct/Nov 2018

46. Match the types of swaps in List I with their underlying mechanisms in List II.
List I: (Type of Swap)
P. Interest Rate Swap
Q. Currency Swap
R. Commodity Swap
S. Equity Swap
List II: (Mechanism)
1. Exchanging payments based on one currency for payments based on another currency.
2. Floating market price is exchanged for a fixed price over a certain period.
3. Exchanging interest payments based on a fixed rate for interest payments based on a floating rate.
4. Involves cash flows based on the performance of a stock or index against a floating interest rate.
(A) P-3, Q-1, R-2, S-4
(B) P-1, Q-3, R-4, S-2
(C) P-3, Q-2, R-1, S-4
(D) P-4, Q-1, R-3, S-2

May/June 2007

47. The following question consists of two statements, one labeled as Assertion (A) and the other as Reason (R). Examine these two statements carefully and select the correct answer.
Assertion (A): Banks often use interest rate swaps to reduce their duration gap.
Reason (R): Banks usually have liabilities with a shorter duration and assets with a longer duration, and an IRS can convert floating rate liabilities into a long-term fixed rate.
(A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
(B) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

Oct/Nov 2025

48. Which of the following pairs regarding the uses of a swaption is INCORRECTLY matched?
(A) Swaption use - Bring a swap into place when hedging becomes necessary
(B) Swaption use - Enhance the yield on an underlying position by buying a swaption

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Oct/Nov 2018

60. Consider the following statements regarding GAP management using Interest Rate Swaps (IRS):

I Banks usually have assets with a shorter duration and liabilities with a longer duration.

II Interest rate swaps can be used to manage duration gap.

III A bank can enter into an interest rate swap to convert a floating rate liability into a long-term fixed rate to match the duration of assets.

Which of the above statement(s) is/are correct?

(A) Only (I) and (II)
(B) Only (II) and (III)
(C) Only (I) and (III)
(D) All (I), (II), and (III)

May/June 2023

61. Under the same swaption scenario as Question 27, if the interest rate decreases and the project is unsuccessful, what is the financial outcome regarding the swaption?

(A) The corporation exercises the option to earn the net interest rate difference.
(B) The corporation receives a full or partial refund of the initial premium paid.
(C) The corporation lets the option expire and forfeits the upfront premium.
(D) The corporation must enter a standard interest rate swap to offset the premium.

Oct/Nov 2009

62. After sharing the swap benefits equally as detailed in Question 55, what is the net borrowing rate for Company A?

(A) 7.85% fixed rate
(B) 8.0% fixed rate
(C) ARR + 0.8% floating rate
(D) ARR + 0.15% floating rate

May/June 2016

63. Which of the following accurately identifies the comparative advantage position of the two companies?

(A) Company A has a comparative advantage in the fixed-rate market.
(B) Company B has a comparative advantage in the floating-rate market.
(C) Company A has a comparative advantage in the floating-rate market.
(D) Company B lacks a comparative advantage in both markets.

Oct/Nov 2019

64. In the swaption scenario from Question 27, if the interest rate increases and the project is unsuccessful, why does the corporation still exercise the option?

(A) Because the exercise of the option will force the underlying project to become successful.
(B) Because the swap rate will likely be higher than the market rate, creating a liability.
(C) Because the market rate exceeds the swap rate, allowing the firm to capture the difference.
(D) Because the premium paid can be recovered directly from the project's allocated funding pool.

May/June 2009

65. What is the net savings for Company B due to the swap arrangement in Question 55?

(A) 0.30% or 30 points
(B) 0.15% or 15 points
(C) 0.50% or 50 points
(D) 0.80% or 80 points

Oct/Nov 2011

66. In the scenario presented in Question 55, what is the total gain in basis points (bps) to be shared between Company A and Company B?

(A) 15 bps
(B) 30 bps
(C) 50 bps
(D) 80 bps

May/June 2010

67. Continuing the scenario from Question 27, if the interest rate increases and the project is successful, what action will the corporation take?

(A) Let the option expire and borrow at the higher market rate.
(B) Sell the swaption back to the dealer at a discount.
(C) Exercise the option, resulting in a funding cost equal to the Market rate + Option premium.
(D) Exercise the option, resulting in a funding cost equal to the Swap rate + Option

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explanation of Assertion (A).
(C) Assertion (A) is true, but Reason (R) is false.
(D) Assertion (A) is false, but Reason (R) is true.

May/June 2005

55. Consider the following statements based on a comparative advantage scenario:
I Company A can borrow at ARR + 80 bps floating or 8% fixed.
II Company B can borrow at ARR + 30 bps floating or 7.2% fixed.
III Company B has a comparative advantage over Company A in the floating-rate market.
IV Company A has a comparative advantage over Company B in the floating-rate market.
Which of the above statement(s) is/are correct?
(A) (I), (II), and (III)
(B) (I), (II), and (IV)
(C) (I), (III), and (IV)
(D) (II), (III), and (IV)

Oct/Nov 2022

56. Match the swap terminology in List I with its respective definition in List II.
List I: (Terminology)
P. Tenor
Q. Notional Principal
R. ARR
S. NPV at initiation
List II: (Definition)
1. A benchmark rate formed through a survey of interbank borrowing rates.
2. Expected to be zero to ensure fairness to both counterparties.
3. The length of time for which payments will be exchanged.
4. A monetary figure used as a part of the calculation to determine payment amounts.
(A) P-3, Q-4, R-1, S-2
(B) P-4, Q-3, R-2, S-1
(C) P-3, Q-1, R-4, S-2
(D) P-2, Q-4, R-1, S-3

May/June 2018

57. Refer to the following scenario to answer the questions that follow:

A bank enters into a 2-year Interest Rate Swap with a Notional Principal of ₹ 10 Million. Payments are made half-yearly following an Actual/365 day count convention. The annualized fixed rate is 5.0%. The floating rate is linked to MIBOR + 1%. During the first half-year, there are 183 days and the MIBOR observation is 4.5%.
What is the floating rate accrual factor for the first half-year?
(A) 0.5014
(B) 0.4986
(C) 0.5000
(D) 0.5041

Oct/Nov 2016

58. Examine the following statements and determine their accuracy:
I The convention is that neither the long nor short position to an interest rate swap pays or receives a premium at initiation.
II At initiation, the net present value (NPV) of the two streams of interest payments must be unequal to provide an arbitrage opportunity.
Which of the following is correct?
(A) Both (I) and (II) are true.
(B) Both (I) and (II) are false.
(C) Statement (I) is true, but Statement (II) is false.
(D) Statement (I) is false, but Statement (II) is true.

May/June 2014

59. Consider the following terms and concepts regarding financial derivatives:
I Tenor: Maturity of the swap.
II Notional Principal: Funds physically exchanged at initiation.
III Swap Dealers: Act as principals taking positions in swaps.
IV Equity Swap: Cash flows based on stock performance vs floating interest rate.
V Swaption: Option to enter a swap at a future date.
Which of the above statement(s) is/are correct?
(A) (I), (II), (III), and (V)
(B) (I), (III), (IV), and (V)
(C) (II), (III), (IV), and (V)
(D) (I), (II), (IV), and (V)

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ANSWERS

1. (D) 1981
The year 1981 marked a significant milestone in the development of the global financial derivatives market. This period saw a major bank facilitate a landmark currency swap involving cash flows in Swiss francs and Deutschmarks. This historic transaction demonstrated the practical utility of swaps for managing currency risk and accessing international capital markets, leading to exponential growth.

2. (C) The difference in borrowing rates for two different borrowers is typically higher in the short-term market than in the long-term market.
In credit markets, rate disparities between borrowers of different credit qualities are usually more pronounced over longer durations. Lenders require higher premiums to compensate for the increased uncertainty and default risk associated with lower-rated parties over time. Consequently, the borrowing rate difference is generally lower in short-term markets compared to long-term markets, driving the need for swaps.

3. (C) Swap Facilitators
Swap facilitators are specialized professionals within the financial industry who focus on the strategic design of derivative instruments. They act as financial engineers, helping clients identify specific exposures and creating customized swap structures to alter or eliminate unwanted risks. Their role is critical for corporations seeking tailored solutions that standard market products may not provide for risk management.

4. (C) Lenders face higher risk when lending to a party with a lower credit rating over a longer term.
Long-term borrowing involves a higher degree of risk for creditors, especially when dealing with entities that have lower credit ratings. Over an extended period, the probability of credit deterioration or default increases significantly. Therefore, lenders demand a larger risk premium for long-term loans than for short-term ones, creating a wider spread between high-rated and low-rated borrowers' rates.

5. (B) As a series of forward contracts.
Conceptually, a swap can be viewed as a sequence of forward contracts bundled together. Each periodic exchange of cash flows in a swap resembles a single forward agreement where parties agree to trade assets or rates at a specific future date. This framework allows for the valuation of complex swap agreements by discounting the individual cash flows of these forwards.

6. (B) Because Company B holds a comparative advantage in one market, allowing both to share gains.
Even if one entity has a better credit rating in all markets, swap arrangements remain beneficial due to the principle of comparative advantage. This occurs when the difference in borrowing costs varies between the fixed and floating rate markets. By borrowing where they have the greatest relative advantage and swapping, both parties can lower their overall interest expenses effectively.

7. (B) A private agreement to exchange future cash flow streams according to a pre-arranged formula.
A swap is fundamentally defined as a customized, over-the-counter financial contract between two private parties. These parties agree to exchange a series of cash flows over a specified period. The calculation of these payments is based on a predetermined formula, which typically involves a notional principal amount and variables such as interest rates, currencies, or commodity prices.

8. (B) To obtain access to a swap when borrowers are uncertain of the funding that will be required.
Swaptions serve as a valuable tool for entities facing uncertainty regarding future funding needs or project approvals. By purchasing a swaption, a borrower gains the right to enter

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into a swap at a future date at a specified rate. This allows the firm to hedge against potential interest rate increases without committing to a swap immediately until necessary.

9. (B) To eliminate the need for paying an upfront premium.
A swaption is an option-based derivative, and like all options, the buyer must pay an upfront premium to the seller to acquire the right. This premium represents the cost of flexibility and protection. Therefore, a swaption cannot be used to avoid paying a premium; rather, the payment of this cost is a fundamental requirement for the contract.

10. (C) The swap is designed to have zero net value for both parties at initiation.
Standard interest rate swaps are structured so that neither party pays an upfront fee to the other. This is achieved by setting the fixed rate at a level where the present value of the expected fixed payments equals the present value of the expected floating payments. Consequently, the contract has a net present value of zero at start.

11. (B) (I), (III), (IV), (II)
Ensuring a swap has zero value at initiation follows a logical sequence. First, all future interest payments are estimated based on forward curves. Next, these estimated cash flows are discounted to the present using benchmark rates. Then, the net present values of both streams are equated. Finally, a fair fixed rate is determined that satisfies this mathematical equilibrium point.

12. (C) ₹ 5 crores
In the Indian financial market, market makers are required to provide two-way quotes for swap transactions to ensure liquidity and standardization. These participants must stand committed to their quoted rates for a minimum notional principal amount. Currently, the prescribed minimum threshold for these transactions is set at five crore rupees, facilitating professional trading and hedging activities among institutional participants.

13. (A) If the interest rate decreases and the project is unsuccessful, the corporation will receive a refund of the premium paid.
When a corporation purchases a swaption, the premium paid at the beginning is a non-refundable cost. This fee covers the right to enter the swap and is forfeited if the option is not exercised. Regardless of whether the project fails or market rates move in a way that makes exercising the option unattractive, the initial premium remains sunk.

14. (C) The fixed rate is set at initiation and remains constant throughout the swap.
In a standard interest rate swap, the fixed rate is agreed upon by both counterparties at the start of the contract. This rate remains unchanged for the entire duration, or tenor, of the agreement. It provides the party paying the fixed rate with certainty regarding their future cash outflows, shielding them from volatility in market interest rate benchmarks over time.

15. (D) The swap becomes an asset for the benefiting party and a liability for the harmed counterparty.
Although a swap starts with zero value, subsequent changes in the benchmark Alternative Reference Rate alter its economic worth. If the floating rate moves in favor of one party, the swap acquires a positive net present value for them, becoming an asset. Conversely, it becomes a liability for the counterparty who must now make relatively higher payments or receive lower income.

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16. (A) Notional Principal
The notional principal is a theoretical amount used as the basis for calculating the interest payments exchanged in a swap. In most interest rate swaps, this principal amount never actually changes hands between the counterparties. It simply serves as the reference figure to which the fixed and floating interest rates are applied to determine the actual periodic cash flow obligations.

17. (A) Federal Funds Rate
The Federal Funds Rate is a benchmark specific to the United States and is not used as a floating rate reference for rupee-denominated swaps in India. In the Indian market, participants

commonly utilize domestic benchmarks such as the Mumbai Interbank Offered Rate, Treasury Bill yields, and Government Securities yields to determine the floating leg of interest rate swap contracts.

18. (A) Agrees to periodically receive a floating rate and pay a fixed rate.
By market convention, the buyer of an interest rate swap, also known as the party in the long position, assumes the obligation to pay a fixed interest rate. In exchange, this party receives periodic payments based on a floating benchmark rate. This position is typically taken by entities expecting market interest rates to rise, allowing them to benefit from higher floating receipts.

19. (D) Swap contracts generally have a shorter maturity compared to forwards and futures.
Swaps are generally characterized by their long-term nature, often spanning several years, which distinguishes them from many other derivatives. While futures and forwards are frequently used for short-term hedging or speculation, swaps are designed for long-term risk management. Therefore, it is incorrect to suggest that swap contracts have shorter maturities than standard forwards or exchange-traded futures contracts.

20. (A) By converting floating-rate debt into long-term fixed rates to match liability and asset durations.
Banks frequently face a duration gap where their assets are long-term while their liabilities are short-term and floating. To manage this interest rate risk, banks use swaps to convert floating-rate liabilities into fixed-rate obligations. This adjustment aligns the duration of their liabilities more closely with their long-term fixed-rate assets, stabilizing the net interest margin against rate fluctuations.

21. (B) (III), (II), (I)
Calculating the floating leg payment follows a systematic approach. First, the floating rate accrual factor is determined based on the days in the period. Second, this factor is used to calculate the specific interest rate for that quarter or half-year. Finally, the total floating payment is computed by applying this periodic rate to the agreed-upon notional principal of the swap.

22. (B) Actual/365
The standard day count convention for interest rate swaps denominated in Indian Rupees is the Actual/365 basis. This means that interest calculations for any given period are based on the exact number of days elapsed, divided by a fixed year length of 365 days. Following this convention ensures consistency and accuracy in cash flow determinations across the Indian financial system.

23. (D) Rate Disparity
Rate disparity describes the phenomenon where the difference in borrowing costs between a high-rated and a low-rated borrower is more significant in the long-term market than in the short-term market. This disparity is a key driver for the swap market, as it creates opportunities for comparative advantage. Entities can exploit these differences to lower their overall cost of borrowing through swaps.

24. (D) The floating rate is fixed at initiation and remains constant.
An essential characteristic of an interest rate swap is that the floating leg changes periodically. The floating rate is reset at specific intervals based on the prevailing market benchmark, such as MIBOR. If the floating rate were fixed at initiation and remained constant, the contract would not be a swap but rather a simple exchange of two fixed payment streams.

25. (B) Swap dealers act only as brokers and never enter into swaps on their own behalf.
Swap dealers play a more active role than simple brokers because they act as principals in transactions. They frequently take positions on their own balance sheets, entering into swaps directly with clients. This provides liquidity to the market and allows dealers to earn spreads by managing a portfolio of offsetting swap positions while assuming the associated counterparty risks themselves.

26. (D) An option to enter into a swap at a future date.
A swaption is a derivative instrument that combines the features of options and swaps. It

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premium.

Oct/Nov 2024

68. If the interest rate decreases and the project is successful, what action should the corporation take and what is the resulting cost of funding?
(A) Let the option expire; Cost = Market rate + Option premium
(B) Exercise the option; Cost = Swap rate + Option premium
(C) Exercise the option; Cost = Market rate - Option premium
(D) Let the option expire; Cost = Swap rate - Option premium

May/June 2017

69. According to the shared benefits from the swap in Question 55, what swap rate does Company B receive from Company A?
(A) 7.2%
(B) 7.85%
(C) 8.0%
(D) ARR + 15 points

Oct/Nov 2005

70. In a different scenario, if the corporation has already entered into an existing swap to lock in borrowing costs but expects interest rates to decrease significantly over the next six months, how can a swaption be utilized?
(A) The corporation can sell a swaption to permanently fix the existing swap rate.
(B) The corporation can enter into a swaption to remove the existing swap if interest rates decrease.
(C) The corporation can buy an equity swap to offset the existing interest rate swap.
(D) The corporation cannot use a swaption if a swap is already in place.

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fixed. Therefore, a party in the short position gains when market reference rates decrease, as their floating payment obligations decline while their fixed receipts remain constant, confirming that Statement II is true.

36. (A) ₹ 275,770
To calculate the floating payment, first determine the floating rate, which is MIBOR plus the spread. With MIBOR at 4.5% and a 1% spread, the annualized rate is 5.5%. Applying the accrual factor for 183 days to the ten million rupee notional principal results in the specific payment. This mathematical process accounts for the exact timing and market benchmark during the period.

37. (A) P-4, Q-2, R-3, S-1
Various participants serve distinct roles in the swap market. The buyer occupies the long position, receiving floating and paying fixed, while the seller takes the short position. Swap facilitators act as engineers who design solutions for clients. Meanwhile, swap dealers function as market makers, acting as both brokers and principals who enter into transactions on their own behalf to provide liquidity.

38. (B) (I), (III), and (IV)
Buyers of swaptions pay an upfront premium to secure a future swap rate. If interest rates rise, even if a project fails, the holder may exercise the option to capture the positive difference between the market and swap rates. Additionally, swaptions are useful for terminating existing swaps that are no longer attractive. However, successful projects with decreased rates would result in expiry.

39. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
By convention, interest rate swaps are structured to have a net present value of zero at initiation. This fairness is achieved by setting a fixed rate that reflects the market's expectation of future floating rates. Because the present value of both payment legs is equalized, neither counterparty starts the agreement with an immediate asset or liability, ensuring a neutral financial starting point.

40. (D) Swap contracts - Exchange-traded agreements
Unlike futures or options that are traded on standardized public exchanges, swaps are over-the-counter instruments. They are private, bilateral agreements negotiated directly between two parties or through intermediaries. This OTC nature allows for high customization of terms like tenor, notional principal, and payment frequency, which is not possible with standardized exchange-traded contracts. Consequently, identifying them as exchange-traded is fundamentally incorrect.

41. (B) (₹ 25,070)
The net cash flow for the short position is the difference between the fixed rate payment received and the floating rate payment made. In this period, the floating payment based on MIBOR exceeds the fixed payment. This results in a negative net cash flow for the short position holder. This outcome illustrates how the short position incurs losses when floating rates rise above expectations.

42. (A) P-3, Q-1, R-4, S-2
A swap buyer's outcome depends on the relationship between MIBOR and the fixed rate. If MIBOR exceeds 5%, the buyer receives more than they pay. If MIBOR is below 5%, they receive less. At exactly 5%, the flows are equal. Furthermore, if a participant expects rates to decrease, they should avoid the long position and instead enter into a short position.

43. (B) (I), (III), and (IV)
Swaps are primary tools for hedging long-term risks, and forward swaps allow parties to commit to future agreements. The swap rate defines the fixed obligation paid to the floating-rate receiver. However, it is incorrect to say swaps have shorter maturities than forwards and futures. In reality, swaps are usually long-term commitments, often extending much further than typical forward or futures contracts.

44. (D) All (I), (II), and (III)
Swaps are characterized by being private, over-the-counter contracts without a centralized exchange. A fundamental requirement of any swap is that at least one set of cash flows must be linked to an uncertain future variable, such

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as a floating interest rate or commodity price. These features combined provide the necessary structure for private parties to customize and hedge long-term financial risks.

45. (C) 5.5%
In this interest rate swap, the floating rate is defined by the MIBOR benchmark plus a fixed spread. Given that the MIBOR observation for the first half-year is 4.5% and the agreed spread is 1.0%, the total annualized floating rate applicable for that specific period is 5.5%. This combined rate is used to calculate the actual interest payment for the period.

46. (A) P-3, Q-1, R-2, S-4
Each type of swap utilizes a unique underlying mechanism to transfer risk. Interest rate swaps exchange fixed for floating payments, while currency swaps involve different denominations. Commodity swaps trade fixed prices for floating market prices, and equity swaps link payments to the performance of stock indices. Matching these mechanisms correctly is essential for understanding the broad application of swaps in global financial markets.

47. (A) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A).
Banks typically hold long-term fixed-rate assets and short-term floating-rate liabilities, creating a duration gap. This exposure makes them vulnerable to rising interest rates. By entering into an interest rate swap to pay fixed and receive floating, the bank effectively converts its floating-rate debt into long-term fixed-rate obligations. This strategy reduces the duration gap and stabilizes the bank's net interest margin.

48. (B) Swaption use - Enhance the yield on an underlying position by buying a swaption
Yield enhancement strategies involving swaptions typically require the market participant to sell the swaption rather than buy it. By selling a swaption, the party receives an upfront premium which increases the total return on their underlying portfolio. Buying a swaption involves paying a premium, which is a cost and therefore does not immediately enhance the yield of an existing asset position.

49. (B) (I), (IV), and (V)
Swap mathematics relies on specific day count conventions and notional amounts. The floating rate payment uses an accrual factor like 183/365 for a half-year period. Total notional principal is the essential base for calculating all periodic payments. While leap years or specific months can change day counts, the typical second half-year accounts for 182 days in a standard non-leap year environment.

50. (D) All (I), (II), and (III)
Calculating floating leg payments involves three distinct steps. First, the accrual factor is determined by dividing the days in the interest period by 365. Second, the annualized floating rate is multiplied by this factor to find the periodic interest rate. Finally, this periodic rate is applied to the notional principal to arrive at the actual monetary payment due for the specified period.

51. (D) ₹ 249,300
To determine the fixed rate payment for the second half-year, the annualized fixed rate of 5.0% is applied to the notional principal of ten million rupees. This result is then adjusted by the day count fraction for the period, which is 182 days divided by 365. This calculation results in a payment of approximately 249,300 rupees for that specific half-year interval.

52. (D) Buyer - Receives a floating rate and pays a fixed rate
In the interest rate swap market, the term buyer refers to the party taking the long position. By standard convention, the buyer agrees to pay a fixed interest rate periodically throughout the tenor of the contract. In return, the buyer receives payments based on a floating benchmark rate. This structure allows the buyer to hedge against or speculate on rising interest rates.

53. (A) Both (I) and (II) are true.
Comparative advantage in swaps allows parties to share the total gains resulting from differences in borrowing spreads. If the total potential gain is 30 basis points, and the parties agree to share this benefit equally, each participant will reduce their borrowing costs by 15 basis points. This total gain is fundamentally derived from

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the variation in comparative advantages across different market types.

54. (D) Assertion (A) is false, but Reason (R) is true.
The assertion is false because borrowing rate differences are generally smaller in short-term markets and larger in long-term markets. The reason is true because yield compression and rate disparities are indeed driven by the increased risks lenders perceive when providing long-term credit to lower-rated borrowers. Swaps exploit these long-term disparities to create value for both high and low-rated borrowing entities.

55. (B) (I), (II), and (IV)
In the provided scenario, Company A can borrow at ARR plus 80 basis points or 8% fixed. Company B can borrow at ARR plus 30 basis points or 7.2% fixed. Comparing the spreads, Company B has a larger advantage in the fixed market (80 bps) than the floating market (50 bps). Therefore, Company A holds the relative comparative advantage in the floating-rate market.

56. (A) P-3, Q-4, R-1, S-2
Swap terminology consists of standardized concepts. Tenor refers to the contract's maturity, while notional principal is the reference amount for payment calculations. ARR represents the benchmark floating rate, often derived from interbank surveys. Finally, the net present value at initiation is designed to be zero to ensure the initial contract is fair and holds no immediate value for either counterparty.

57. (A) 0.5014
The floating rate accrual factor is determined by taking the actual number of days in the payment period and dividing it by the year base. For a first half-year containing 183 days under an Actual/365 day count convention, the calculation is 183 divided by 365. This results in an accrual factor of approximately 0.50136986, which is rounded to four decimal places.

58. (C) Statement (I) is true, but Statement (II) is false.
Standard swap contracts are designed to have zero initial value, meaning neither party pays a premium at the start. This ensures that the fixed rate is perceived as fair. However, Statement II is false because the net present value of the two payment streams must be equal at initiation, not unequal, to eliminate any immediate arbitrage opportunity for either side.

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59. (B) (I), (III), (IV), and (V)
Swaps involve several key elements: the tenor defines the maturity, and dealers act as principals taking positions. Equity swaps link cash flows to stock or index performance, while swaptions provide the future right to enter a swap. However, the notional principal is merely a reference value for calculations and is not physically exchanged between the counterparties at the contract's initiation.

60. (B) Only (II) and (III)
Interest rate swaps are effective tools for managing a bank's duration gap. Banks typically have liabilities with shorter durations and assets with longer durations. By entering into a swap to pay fixed and receive floating, a bank converts its floating-rate liabilities into long-term fixed-rate obligations. This strategy aligns the duration of liabilities with assets, mitigating the risk of interest rate fluctuations.

61. (C) The corporation lets the option expire and forfeits the upfront premium.
If interest rates decrease and the underlying project is unsuccessful, the swaption becomes worthless to the holder. There is no reason to exercise the right to pay a fixed swap rate that is higher than current market rates, especially with no project to fund. Consequently, the buyer allows the option to expire, and the initial premium paid to the seller is lost.

62. (A) 7.85% fixed rate
Company A holds a comparative advantage in the floating rate market but desires a fixed rate. In a swap where benefits are shared equally, each party gains 15 basis points from the 30-point total gain. Since Company A's standalone fixed borrowing rate is 8.0%, the swap allows them to achieve a net borrowing cost of 7.85% fixed by utilizing their comparative advantage.

63. (C) Company A has a comparative advantage in the floating-rate market.
Comparative advantage is determined by looking at where the relative difference in borrowing costs is smallest for the lower-rated firm. Company B has a larger absolute advantage in both markets, but its advantage is most significant in the fixed-rate market. Consequently, the lower-rated Company A has a relative comparative advantage in the floating-rate market, providing the basis for a mutually beneficial swap.

64. (C) Because the market rate exceeds the swap rate, allowing the firm to capture the difference.
Even if the project fails, a swaption remains valuable if market interest rates have risen above the strike rate. By exercising the option, the corporation can enter a swap that is worth more than its cost. This allows the firm to capture the positive spread between the prevailing higher market rates and the locked-in lower swap rate, partially offsetting the project loss.

65. (B) 0.15% or 15 points
The total gain from the swap arrangement is calculated by finding the difference between the spreads in the fixed and floating markets. In this scenario, the total gain available is 30 basis points. When these benefits are distributed equally between the two companies, each party, including Company B, realizes a net savings of 15 basis points or 0.15% on their borrowing costs.

66. (B) 30 bps
The total gain in a swap is the difference between the borrowing cost spreads of two parties across different markets. Here, the fixed rate spread is 80 basis points and the floating rate spread is 50 basis points. Subtracting the smaller spread from the larger spread results in a total gain of 30 basis points, which represents the total potential savings available for sharing.

67. (D) Exercise the option, resulting in a funding cost equal to the Swap rate + Option premium.
When interest rates increase and the project is successful, exercising the swaption is the most rational choice. This allows the corporation to fund the project at the predetermined fixed swap rate, which is lower than the current market rate. The final effective cost of funding for the firm will be the sum of this swap rate and the initial option premium paid.

68. (A) Let the option expire; Cost = Market rate + Option premium
If interest rates have decreased, the corporation can borrow more cheaply in the open market than through the swaption's fixed rate. Since the project is successful, the firm needs funding but will choose to let the swaption expire unused. The total cost of funding will be the current lower market rate plus the sunk cost of the upfront option premium already paid.

69. (B) 7.85%
In the swap arrangement designed to share gains equally, Company B agrees to receive a fixed rate from Company A that reflects Company A's shared benefit. Since Company A's original fixed rate was 8.0% and they gain 15 basis points through the swap, the resulting rate transferred between the parties is 7.85%. This allows both companies to optimize their respective borrowing positions effectively.

70. (B) The corporation can enter into a swaption to remove the existing swap if interest rates decrease.
Swaptions are versatile tools that can be used to manage or terminate existing swap positions. If a corporation has already locked in a high fixed rate but expects market rates to fall, it can purchase a swaption. This gives the firm the right to enter into an offsetting swap at a future date, effectively neutralizing the original contract and its associated interest obligations.

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